Case No. D60/05

Profits tax – whether expenditure of a capital nature – anti-avoidance - section 61A – whether appellant obtained tax benefit – whether sole or dominant intention to obtain tax benefit – whether Commissioner entitled to consider assessments afresh.

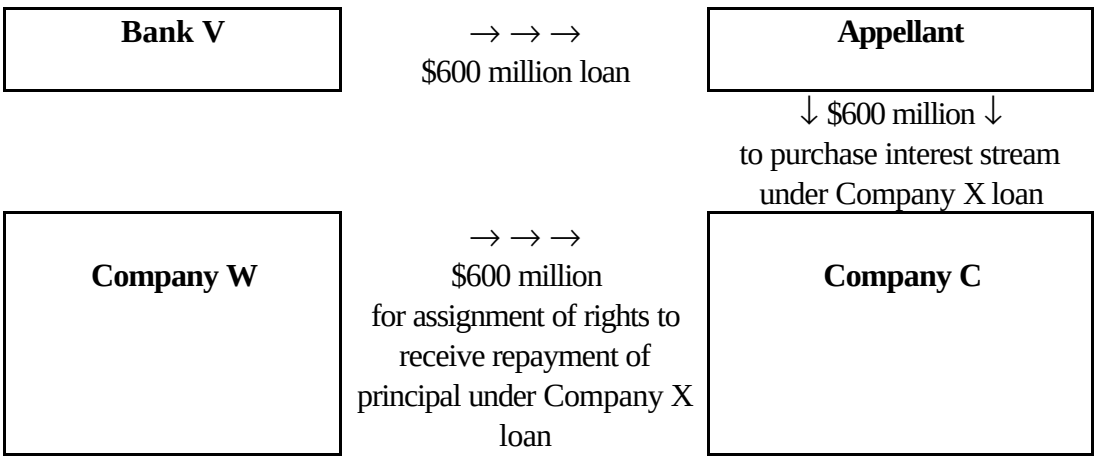
Panel: Kenneth Kwok Hing Wai SC (chairman), Patrick James Harvey and Thomas Mark Lea.

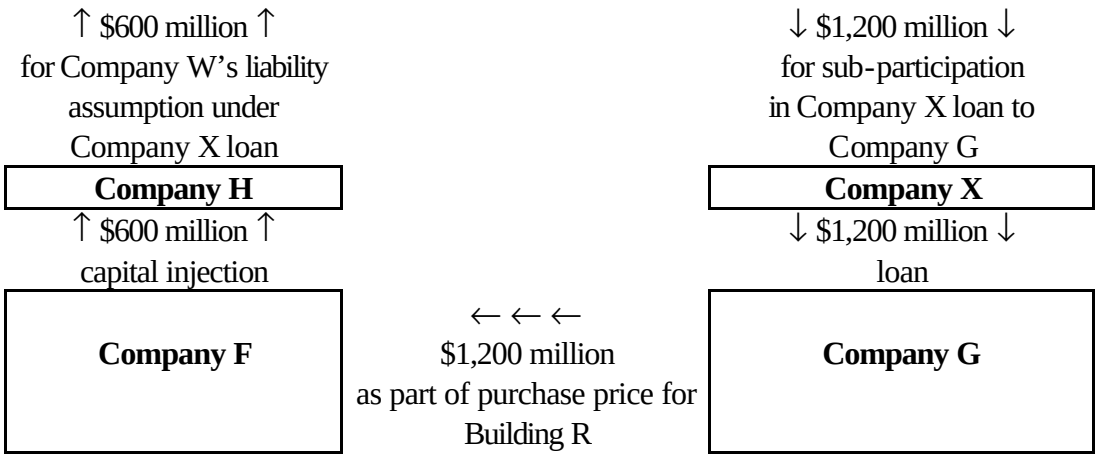
Dates of hearing: 2, 3, 4, 5, 8 and 9 March 2004.
Date of decision: 1 December 2005.

This was an appeal against the CIR's profits tax assessments against the appellant for the years of assessment 1988/89 to 1996/97. The appellant was a company within a group which had structured a scheme involving loan and sub-participation arrangements with the assistance of professional tax advice.

In the books of the appellant, a total of HK$606,202,680 was written off as 'deferred expenditure' in 1988/89. This expenditure was amortised by the appellant each year from 1988/89 to 1996/97 and it was described in its accounts as 'consideration paid to obtain a right to receive interest payments from a fellow subsidiary and legal and professional fees paid in respect of a loan'.

The Board found that the fund flow on the implementation of the scheme occurred in the following manner:





Essentially, the appellant had paid HK$600 million in exchange for Company C's assignment of its right to receive amounts under a sub-participation agreement. Company C had paid HK$1.2 million to Company X to sub-participate in Company X's loan of an equivalent amount to Company G. Effectively, therefore, the appellant received net monthly payments from Company G.

The issues before the Board was whether the HK$606,202,680 was a capital expense, and whether the appellant and the other participants in the scheme had entered into it for the dominant purpose of enabling the appellant to obtain a tax benefit. The appellant also objected to the Board considering the prior question, as it contended that the original assessments were made under section 61A only.

Held:

1. In considering an objection to the assessement, the CIR was under a duty to act de novo and to determine afresh what should be the proper assessment. Accordingly, the fact that the assessments were originally made under section 61A, which was not of itself a charging provision, did not preclude the CIR from considering whether the expenditure was deductible under section 16(1). Mok Tsze Fung v CIR [1962] HKLR 258, CIR v The Hong Kong Bottlers Ltd [1970] HKLR 581, CIR v DH Howe [1977] HKLR 436 applied.

2. Under section 17(1)(c), expenditure is not deductible if it is of a capital nature. In the present case, in exchange for its payment of HK$600 million, the appellant acquired a contractual right to receive monies to last for years. The cost of acquiring permanent structure from which income was to be derived was of a capital nature. Wharf Properties Limited v CIR [1997] AC 505, Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd [1964] AC 948 applied.

3. In order for section 61A to apply, there must be a tax benefit on the appellant. A reduction in the amount of tax satisifies this requirement. There is no requirement of any pre-existing liability to tax. In the present case, the scheme reduced the amount of tax payable by the appellant, and hence it was conferred a tax benefit. Yick Fung Estates Limited v CIR [2000] 1 HKLRD 381, Cheung Wah Keung v CIR [2002] 3 HKLRD 773 applied.

4. It was clear that the implementation of the scheme involved an artificial and circular flow of HK$600 million. Having regard to the 7 matters in section 61A(1), the Board held that there was a dominant purpose on the part of the appellant and the other participants in the scheme to enable the appellant to obtain a tax benefit. Yick Fung Estates Limited v CIR [2000] 1 HKLRD 381 applied.

Appeal dismissed.

Cases referred to:

Yick Fung Estates Ltd v CIR [1998] 4 HKC 700 (HC)
Yick Fung Estates Ltd v CIR [2000] 1 HKC 588 (CA)
WP Keighery Pty Ltd v FCT [1956-1957] 100 CLR 66
Newton v Commissioner of Taxation [1958] AC 450
Mangin v IRC [1971] AC 739
CIR v Swire Pacific Ltd [1979] HKLR 612
Ure v FCT [1981] 11 ATR 484
CIR v Challenge Corporation [1987] 1 AC 155
FCT v Peabody [1993-1994] 181 CLR 359
CIR v Cosmotron Manufacturing Co Ltd [1997] 2 HKC 417
Hitch v Stone (Inspector of Taxes) [1999] STC 431
O' Neil v CIR [2001] 1 WLR 1212
Eastern Nitrogen Ltd v Commissioner of Taxation (2001) 108 FCR 27
Hart and Another v Commissioner of Taxation 196 ALR 636
Cheung Wah Keung v CIR [2002] 3 HKLRD 773 (CA)
D44/92, IRBRD, vol 7, 324
Pettigrew v FCT (1990) 92 ALR 261 (Fed Ct of Aust – Full Ct)
FCT v Spotless Services Ltd (1996) 34 ATR 183 (HC of Aust)
FCT v Consolidated Press Holdings and Ors (2001) 47 ATR 229 (HC of Aust)
Vincent v FCT (2002) 50 ATR 20 (Fed Ct of Aust – Single Judge)
Vincent v FCT (2002) 51 ATR 18 (Fed Ct of Aust – Full Ct)
FCT v Myer Emporium Ltd (1987) 163 CLR 199 (HC of Aust)
CIR v Wattie [1998] STC 1160 (PC)
Sun Newspapers Ltd v FCT (1938) 61 CLR 337 (HC of Aust)

Wharf Properties Ltd v CIR 4 HKTC 310 (HC/CA/PC)
Henriksen v Grafton Hotel Ltd [1942] 24 TC 453 (CA)
Atherton v British Insulated and Helsby Cables Ltd [1926] AC 205 (HL)
Regent Oil Co Ltd v Strick [1966] AC 295 (HL)
Mok Tsze Fung v CIR [1962] HKLR 258
CIR v The Hong Kong Bottlers Ltd [1970] HKLR 581
CIR v DH Howe [1977] HKLR 436
Wharf Properties Limited v Commissioner of Inland Revenue [1997] AC 505
Court of Appeal, [1995] 2 HKLR 552
Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd [1964] AC 948

Barrie Barlow Counsel and Jane Lo Counsel instructed by Messrs Kwok & Yih, Solicitors, and assisted by Curtis Ng, tax manager and Jennifer Wong, tax partner, both of KPMG, certified public accountants, for the taxpayer.

Ambrose Ho SC instructed by Herbert Li, Senior Government Counsel of the Department of Justice and assisted by Tsui Siu Fong, senior assessor, Tse Yuk Yip, senior assessor, Lai Wing Man, assessor, and Ma Wai Fong, senior assessor for the Commissioner of Inland Revenue.

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Decision:

1. This is an appeal against the Determination of the Commissioner of Inland Revenue dated 12 August 1998 whereby:

(a) Profits tax assessment for the year of assessment 1988/89 under charge number 1-4767640-89-8, dated 24 March 1995, showing assessable profits of $46,402,759 with tax payable thereon of $7,888,469 was confirmed.

(b) Profits tax assessment for the year of assessment 1989/90 under charge number 1-4767641-90-8, dated 24 March 1995, showing assessable profits of $57,104,806 with tax payable thereon of $9,422,292 was confirmed.

(c) Profits tax assessment for the year of assessment 1990/91 under charge number 1-4767642-91-2, dated 24 March 1995, showing assessable profits of $62,470,522 with tax payable thereon of $10,307,636 was confirmed.

(d) Profits tax assessment for the year of assessment 1991/92 under charge number 1-4767643-92-7, dated 24 March 1995, showing assessable profits of $69,363,125 with tax payable thereon of $11,444,915 was confirmed.

(e) Profits tax assessment for the year of assessment 1992/93 under charge number 1-4767644-93-1, dated 24 March 1995, showing assessable profits of $75,938,219 with tax payable thereon of $13,289,188 was confirmed.

(f) Profits tax assessment for the year of assessment 1993/94 under charge number 1-4767645-94-2, dated 24 March 1995, showing assessable profits of $84,005,872 with tax payable thereon of $14,701,027 was increased to assessable profits of $84,829,978 with tax payable thereon of $14,825,246.

(g) Profits tax assessment for the year of assessment 1994/95 under charge number 1-5043057-95-3, dated 29 October 1997, showing assessable profits of $91,978,846 with tax payable thereon of $15,176,509 was confirmed.

(h) Profits tax assessment for the year of assessment 1995/96 under charge number 1-3130082-96-2, dated 29 October 1997, showing assessable profits of $100,432,031 with tax payable thereon of $16,571,285 was confirmed.

(i) Profits tax assessment for the year of assessment 1996/97 under charge number 1-1112816-97-4, dated 2 March 1998, showing assessable profits of $11,340,308 with tax payable thereon of $1,871,150 was confirmed.

AGREED FACTS

2. The parties agreed the following facts and we find them as facts.

Background

3. The appellant appeals against the Determination of the Commissioner of Inland Revenue ('the CIR') dated 12 August 1998 and the assessments for the 1988/89 to 1996/97 years of assessment issued by the Assistant Commissioner under section 61A(2) of the Inland Revenue Ordinance, Chapter 112 ('the Ordinance').

4. The principal activity of the appellant at all relevant times was and still is 'to arrange financing activities' or 'loan financing', as described by the directors in their reports attached to the appellant's financial statements.

5. Company F, a private company incorporated in Hong Kong on 10 January 1984, has been at all relevant times the beneficial owner of 100 per cent of the share capital in the following companies:

(a) The appellant – a private company incorporated in Hong Kong on 11 March 1988;

(b) Company G – a private company incorporated in Hong Kong on 24 July 1987; and

(c) Company H – a private company incorporated in Country I on 12 April 1988.

6. Company J, a private company incorporated in Hong Kong on 3 June 1980, has been at all relevant times the beneficial owner of 100 per cent of the share capital in Company F. Company K, a private company incorporated in Hong Kong on 31 October 1975, has been at all relevant times the beneficial owner of 100 per cent of the share capital in Company J. Group L presently known as Holdings Company M, a private company incorporated in Hong Kong on 29 July 1965, has been at all relevant times the beneficial owner of 100 per cent of the share capital in Company K.

7. Company N, a private company incorporated in Country O on 4 July 1989, has been the ultimate holding company of the Group since 7 November 1989. Copies of the group organisation chart showing the relevant companies as at 31 March 1987 and 31 May 1988 were attached to the Statement of Agreed Facts as Annex 1 and Annex 2. The group structure shown in Annex 2 has remained unchanged since 31 May 1988.

8. On 20 May 1985, the Hong Kong Government granted to Company F at a consideration of HK$302,000,000, under Conditions of Sale No xxxxx, a lease of Inland Lot No P being a 3,429 square meters site in District Q for a term of 75 years commencing on that day.

9. On 28 August 1985, Company F obtained a syndicated loan facility in the sum of HK$360,000,000 for the purposes of (a) re-financing part of the land premium; and (b) financing in full the construction costs of a commercial building to be built on the site and to be known as Building R. The Bank S was the agent for the syndicated loan facility. A debenture incorporating a building mortgage and floating charge was created over the land and building in favour of Bank S.

10. Company F completed the construction of Building R on the lot at a cost of around HK$596,000,000 (including HK$302,000,000 land premium) during the year ended 31 March 1988. The permit to occupy Building R was issued by the Building Authority on 11 May 1987.

11. Company F had an outstanding accrued liability of HK$357,000,000 under the loan facility from Bank S, amounts due to group companies totaling HK$209,000,000 and creditors and accrual balances in the sum of HK$30,000,000 as at 31 March 1988.

12. Starting from early 1987, units in Building R were available for letting for terms of three years to six years.

13. In January 1988, Building R was valued by a firm of surveyors, Company T, as having a market value of HK$1.31 billion.

14. In the Annual Report of Group L for the year ended 31 March 1988, at pages 25 and 26, the directors stated:

(a) 'The [Building R] if fully leased is expected to generate annual rental of about HK$100 million.'

(b) 'The company' s major development, [Building R], was fully leased at year end. Over three quarters of the tenants are international companies.'

Loan arrangements

15. By a Loan Agreement dated 4 May 1988 made between the appellant as Borrower, Bank U – Asia as the Arranger, Bank V as Lead Manager and Agent and others as Lenders, the appellant was granted a loan facility of HK$600,000,000 at a floating rate.

16. By a Notice of Drawdown dated 4 May 1988, the appellant gave notice to Bank V that it wished to draw down the advance in the following manner:

(a) by way of a cashier cheque in the amount of HK$358,223,214 in favour of Bank S; and

(b) by way of a cashier cheque in an amount equal to the residue of the HK$600,000,000 loan facility, that is HK$241,776,786, payable to Company W for credit to the account of the appellant.

17. By a letter dated 9 May 1988, Company X confirmed the receipt from Company G of the application for the 'Term Loan of Up to HK$1,200,000,000'.

18. By a Loan Agreement ('the Loan Agreement') dated 9 May 1988 made between Company G and Company X, the former obtained a Loan Facility of HK$1,200,000,000 at a fixed rate of 9.375 per cent per annum from Company X. The loan would be repayable by Company G in full in one lump sum at the end of eight years.

19. By a Notice of Drawdown dated 9 May 1988, Company G notified Company X that it wished to draw down the advance of HK$1,200,000,000 on 11 May 1988.

20. By a Guarantee dated 9 May 1988, Group L and Company K jointly and severally guaranteed to Company X the due and punctual payment by Company G of all indebtedness under the loan facility of HK$1,200,000,000.

21. By a Sub-Participation Agreement ('the Sub-Participation Agreement') dated 9 May 1988, Company C subsequently renamed as Company Y, paid to Company X a purchase price of HK$1,200,000,000 in consideration of the sub-participation of the HK$1,200,000,000 loan due by Company G and receiving the full rights and obligations of Company X under the Loan Agreement.

22. By an Assignment dated 9 May 1988, Company C assigned to the appellant all of its right to receive amounts of interest from Company G under the Loan Agreement and the appellant agreed to pay a purchase price of HK$600,000,000.

23. By a letter dated 9 May 1988, Company X informed Company G that the interest payable under the Loan Agreement should be paid to the appellant.

24. By a Swap Agreement ('Swap Agreement') dated 9 May 1988, Bank U – Asia agreed to pay a fixed rate amount to Company G on certain specified dates and Company G agreed to pay a floating rate amount to Bank U – Asia on certain specified dates and Company G paid a fee of HK$50,000 to Bank U – Asia, as the adviser on the Swap Agreement, for arranging for the interest swap. The floating rate amount was arrived at by applying HIBOR plus a margin to a diminishing 'notional principal' of HK$600,000,000 and a 'principal installment'. The fixed rate amount was arrived at by applying a fixed rate of 9.375% per annum to HK$1,200,000,000.

25. By a Supplemental Swap Agreement ('Supplemental Swap Agreement') dated 9 May 1988 between Bank U – Asia, the appellant and Company G, the appellant agreed to perform all the obligations of Bank U – Asia under the Swap Agreement and Company G agreed to perform its obligations under the Swap Agreement as if the appellant were Bank U – Asia named in the Swap Agreement.

26. By a Deed of Covenant ('Deed of Covenant') dated 9 May 1988 between Company W, Company H and Company C, Company H agreed to pay a sum of HK$600,000,000 to Company W and Company W covenanted to discharge or procure to be discharged Company X's obligation to pay to Company C the principal of HK$1,200,000,000 under the Loan Agreement. All directors of Company H were Hong Kong residents and they held all their board meetings in Hong Kong.

27. By a letter dated 10 May 1988, Company G instructed Company W as follows:

> '(1) [Company G] has recently agreed to borrow HK$1,200 million from [Company X] with drawdown to occur on May 11, 1988. As soon as [Company X] notifies you that the proceeds of drawdown are available, credit [Company G's] account with this amount of HK$1,200 million.
>
> (2) [Company G] has agreed to purchase [Building R] from [Company F] which we understand also has an account with [Company W]. As soon as the proceeds of the borrowing from [Company X] referred to in (1) above have been credited to [Company G's] account, debit [Company G's] account and credit [Company F's] account with HK$1,200 million in partial satisfaction of the purchase consideration due to [Company F].'

28. By a letter dated 10 May 1988, Company F instructed Company W as follows:

> '(1) [Company F] has recently agreed to sell the [Building R] to [Company G] for HK$1,310 million of which amount HK$1,200 million is to be paid on May 11, 1988. As soon as [Company G] notifies you that it is in a position to pay the aforementioned HK$1,200 million, credit the same to [Company F's] account.
>
> (2) [Company F] has an overseas subsidiary, [Company H] which we understand also has an account with [Company W]. We propose to increase the capital of [Company H] by subscribing for new shares in the same. Accordingly, once the monies referred to in (1) above have been credited to [Company F's] account, debit [Company F's] account with HK$599,999,999 and credit

[Company H's] account with HK$599,999,999 in satisfaction of the issue price for the new [Company H] shares issued to us.

(3) At the request of [Company F], [Company C] recently repaid on our behalf certain borrowings by [Company F] from [Bank S] in the amount of HK$358,223,214.04. We understand that [Company C] has an account with [Company W]. Accordingly, once the monies referred to in (1) above have been credited to [Company F's] account, debit [Company F's] account in the amount of HK$358,223,214.04 and credit [Company C's] account in the same amount in discharge of this inter-company obligation.'

29. By a letter dated 10 May 1998, in connection with the operation of the appellant's HK$ current account with Company W, the appellant wrote:

'(1) [the appellant] is the borrower under a syndicated loan arrangement with [Bank V] and others as the lenders. On May 11, 1988, [Bank V] will deliver to you a cashier's cheque in the amount of HK$241,776,785.96. You should credit this amount to [the appellant's] account.

(2) [the appellant] has recently been offered the opportunity to acquire the rights of a company called [Company C] in a Sub-Participation Agreement vis-à-vis a stream of fixed interest payments due under an eight year loan in the amount of HK$1,200 million. The purchase price for these rights is HK$600 million. As soon as the amount referred to in (a) above has been received into [the appellant's] account, debit [the appellant's] account in the amount of HK$241,776,785.96 and credit the account which we understand [Company C] maintains with [Company W] in the amount of HK$241,776,785.96. This payment will be in partial satisfaction of the purchase price due to [Company C].'

30. By a letter dated 10 May 1988, Company H instructed Company W as follows:

'(1) [Company H] has recently increased its authorized share capital to HK$600 million and proposes to increase its issued share capital to the same amount by issuing to [Company F] 99,999,999 new shares in [Company H] of HK$6 each. As soon as [Company F] notifies you that it is in a position to satisfy the issue price for the new shares in [Company H] to be issued to it, please credit [Company H's] account with the amount of HK$599,999,994.

(2) As you are aware, [Company H] has entered into a contractual relationship with [Company W], pursuant to which [Company W] has agreed to perform certain actions in return for a non-refundable fee of HK$600 million.

> [Company H] proposes to settle this fee from the proceeds of the newly issued capital of [Company H] referred to in (1) above. As soon as the issue price of the new capital of [Company H] is credited to our account, please debit our account in the amount of HK$600 million and credit the appropriate account of [Company W] with [Company W] in Hong Kong in the amount of HK$600 million.'

31. By an Assignment of Rental ('Rental Assignment') dated 11 May 1988, as a condition precedent to utilise the Syndicated Loan Facility of HK$600,000,000 by the appellant, Company G assigned to Bank V all the rentals derived from Building R.

32. By a First Legal Charge ('First Legal Charge') dated 11 May 1988, as a condition precedent to utilise the Syndicated Loan Facility of HK$600,000,000 by the appellant, Company G charged Building R onto Bank V.

33. By a letter dated 11 May 1988, Company C gave notice to the appellant to pay the purchase price under the Assignment in the following manner:

(i) by way of a cashier cheque in the amount of HK$358,223,214 in favour of Bank S; and

(ii) by way of direct transfer an amount of HK$241,776,786 to Company C's account with Company W.

34. By an Assignment dated 11 May 1988, Company F assigned to Company G Building R at a consideration of HK$1,310,000,000.

35. By a letter dated 11 May 1988, Bank V authorised the appellant and Company G to grant or renew tenancies and to accept surrenders of tenancies and otherwise manage Building R and for moneys to be released from the rental account as provided in the Rental Assignment.

36. On 11 May 1988, Company K received a sum of HK$241,776,786 for settlement of the inter-company balances due by Company F. The sum of HK$241,776,786 was applied by Company K in the following manner:

(a) HK$200,000,000 was paid to Company Z for the following purposes:

	HK$ million
Subscription of shares in Company Z	58
Repayment of inter-company loan	75
Advances to Company Z for working capital use	67

(b) HK$4,000,000 was advanced to Company AA for financing its working capital requirements.

(c) HK$4,000,000 was advanced to Company AB for funding its working capital requirements.

(d) HK$2,000,000 was paid to Company AC for financing its working capital.

(e) HK$10,000,000 was advanced to Company AD for working capital financing purposes.

(f) HK$21,000,000 was retained by Company K to reduce its bank overdraft balance and for working capital use.

37. On 22 September 1989, Company W, Company H and Company C entered into a supplemental deed to supplement the Deed of Covenant.

Additional information/subsequent events

38. The Controller of Bank AE by a letter dated 30 March 1993, informed the CIR that Company X was dissolved on 29 August 1990.

39. By a letter dated 11 April 1996, Company H gave an instruction to Company C, pursuant to Clause 3(A)(i) of the Deed of Covenant, requesting the latter to instruct Company X to release Company G from its obligation to repay the loan principal of HK$1,200,000,000.

40. By a letter dated 20 April 1998, Company W instructed the liquidators of Company X to release Company G from its obligation to repay the loan principal of HK$1,200,000,000.

41. Company C was a wholly owned subsidiary company of Bank U – Asia. Bank U – Asia was indirectly held by Company W to the extent of 50 per cent of its shareholding.

Accounts and profits tax returns

42. In its 1988/89 to 1996/97 profit and loss accounts, the appellant recorded the following particulars:

	1988/89	**1989/90**	**1990/91**	**1991/92**
	HK$	**HK$**	**HK$**	**HK$**
Interest income-Company G	100,171,233	112,500,000	112,500,000	112,500,000
Loss on interest swap-Company G	(7,219,220)	(2,510,469)	(7,214,280)	(17,787,187)

		92,952,013	109,989,531	105,285,720	94,712,813
Interest expenses		(46,507,024)	(52,856,875)	(42,744,018)	(25,283,453)
Deferred expenditure w/o		(47,134,883)	(57,907,460)	(63,316,507)	(70,204,164)
Other expenses		(48,229)	(27,850)	(71,180)	(66,235)
		93,690,136	110,792,185	106,131,705	95,553,852
Profit/(Loss)		(738,123)	(802,654)	(845,985)	(841,039)

	1992/93	**1993/94**	**1994/95**	**1995/96**	**1996/97**
	HK$	**HK$**	**HK$**	**HK$**	**HK$**
Interest income-Company G	112,500,000	112,500,000	112,500,000	112,500,000	12,328,767
Loss on interest swap-Company G	(21,823,779)	(18,082,598)	(9,844,197)	(5,657,227)	(69,163)
	90,676,221	94,417,402	102,655,803	106,842,773	12,259,604
Interest expenses	(14,689,722)	(9,544,898)	(10,637,522)	(5,927,013)	(371,972)
Deferred expenditure w/o	(76,761,303)	(84,417,925)	(92,793,086)	(101,690,564)	(11,976,787)
Other expenses	(48,280)	(42,526)	(39,435)	(26,400)	(44,285)
Bank charges	-	-	-	(457,329)	(503,039)
	91,499,305	94,005,349	103,470,043	108,101,306	12,896,083
Profit/(Loss)	(823,084)	(412,053)	(814,240)	(1,258,533)	(636,479)

43. A note to each of the profit and loss accounts reads as follows:

> ' The deferred expenditure represents consideration paid to obtain a right to receive interest payments from a fellow subsidiary and legal and professional fees paid in respect of a loan. The amortisation of such expenses represents deductible expenses on the basis that the corresponding repayment of the consideration is treated as taxable income in the Profits Tax Computation.'

44. In its 1988/89 to 1996/97 profits and loss accounts, Company G recorded the following particulars:

	1988/89	**1989/90**	**1990/91**	**1991/92**
	HK$	**HK$**	**HK$**	**HK$**
Rental income	87,889,449	104,815,897	119,818,159	169,278,198
Disposal profit	-	-	-	-
Management fee	3,478,764	4,350,820	1,491,646	1,579,702
Interest income - onshore	2,262,295	2,899,761	10,622,639	32,803,904
Interest income - offshore	-	-	-	-
Gain from swap transaction - the appellant	7,219,200	2,510,469	7,214,280	17,787,187
Other income	142,617	1,472,960	5,598,754	4,579,329
	100,992,325	116,049,907	144,745,478	226,028,320
Agency fee	186,707	659,040	2,075,444	18,697,957
Amortization	3,096,215	2,902,703	-	-
Deferred charges	291,042	317,500	446,666	188,583
Depreciation	2,650,956	2,915,172	2,713,186	1,786,406
Fixed assets w/o	-	1,292,152	2,767,048	232,021

Insurance	211,010	339,775	490,100	297,786
Interest - the appellant	100,171,233	112,500,132	112,500,000	112,500,000
Interest - bank loan	-	-	7,342,467	28,191,095
Interest - related companies	-	-	-	4,915,955
Legal and professional fees	132,536	500,353	1,069,233	330,453
Management fees	229,787	234,461	228,987	4,800,000
Donations	-	-	-	-
Rates/Rent and rates	118,315	146,452	589,967	3,792,409
Repair and maintenance	162,646	72,243	1,021,711	271,167
Other expenses	119,374	380,862	1,430,520	2,339,720
	107,369,821	122,260,845	132,675,329	178,343,552
Profit/(Loss)	(6,377,496)	(6,210,938)	12,070,149	47,684,768

	1992/93	**1993/94**	**1994/95**	**1995/96**	**1996/97**
	HK$	**HK$**	**HK$**	**HK$**	**HK$**
Rental income	160,285,156	163,667,511	111,769,705	113,860,531	114,215,536
Disposal profit	-	1,089,080,200	891,142,322	-	-
Management fee	3,219,175	4,338,224	-	-	-
Interest income - onshore	25,069,648	25,155,349	3,853,864	3,678,936	10,982,289
Interest income - Offshore	1,978,613	2,106,382	3,025,562	-	-
Gain from swap transaction - the appellant	21,823,779	18,082,597	9,844,196	5,657,227	69,163
Other income	3,618,243	6,547,788	7,577,062	6,462,946	10,362,704
	215,994,614	1,308,978,051	1,027,212,711	129,659,640	135,629,692
Agency fee	12,214,692	14,671,057	7,108,247	9,696,953	9,601,508
Amortization	-	-	-	-	-
Deferred charges	317,500	978,959	-	-	-
Depreciation	1,702,212	2,058,358	1,128,334	1,681,841	2,219,703
Insurance	305,459	341,875	220,043	9,052,084	8,446,743
Interest - the appellant	112,500,000	112,500,000	112,500,000	112,500,000	12,328,767
Interest - bank loan	18,781,952	24,587,012	-	-	24,018,519
Interest - related companies	15,231,373	8,897,436	11,252,968	12,650,862	36,566,077
Legal and professional fees	500,037	1,038,245	650,200	705,945	78,100
Management fees	17,400,000	20,000,000	29,910,590	27,598,470	49,959,405
Donations	-	-	-	27,000,000	-
Rates/Rent and rates	271,791	620,040	966,942	769,722	1,520,666
Repair and maintenance	3,709,072	328,515	479,328	812,051	1,333,867
Other expenses	794,502	1,014,926	2,559,097	2,120,564	1,529,096
	183,728,590	187,036,423	166,775,749	204,588,492	147,602,451
Exceptional gain	-	-	-	-	1,200,000,000
Profit/(Loss)	32,266,024	1,121,941,628	860,436,962	(74,928,852)	1,188,027,241

45. In its 1988/89 accounts, the appellant described the 'Deferred Expenditure' written off in note 5 in the following terms:

	HK$
Consideration paid to obtain the right to receive interest payments from a fellow subsidiary	600,000,000
Legal and professional fees paid in respect of the loan	6,202,680
	606,202,680
Less: Amortization for the period	(47,134,883)
Balance at 31 March 1989	559,067,797

A similar note is attached to the appellant's accounts for each of the years from 1989/90 to 1996/97.

46. For the year of assessment 1988/89, Company G claimed for deduction the following two sums:

	HK$
Arrangement fee paid to Bank U – Asia in respect of the $1,200 Million Loan:	2,540,000
Arrangement fee paid to Bank U – Asia in respect of the Swap Agreements:	50,000
	2,590,000

47. The following sums were paid to Bank V by the appellant as interest in respect of HK$600,000,000 drawn down under the syndicated facility:

Year of assessment	**Interest expenses**
	HK$
1988/89	46,507,024
1989/90	52,856,875
1990/91	42,744,018
1991/92	25,283,453
1992/93	14,689,722
1993/94	9,544,898

48. Upon the partial disposal of the units in Building R, the loan from Bank V was fully repaid on 17 February 1994. The assessor was provided with schedules showing:

(a) the repayment of principal and payment of interest to Bank V by the appellant;

(b) the breakdown of interest expenses charged in the accounts of Company G; and

(c) the breakdown of interest paid and the gain on swap transaction recorded in the accounts of Company G.

49. In its profits tax returns, the appellant declared the following losses:

Year of assessment	**Losses**
	HK$
1988/89 (Note 1)	(732,124)
1989/90	(802,654)
1990/91	(845,985)
1991/92	(841,039)
1992/93	(823,084)
1993/94 (Note 2)	(412,053)
1994/95	(814,240)
1995/96	(1,258,533)
1996/97	(636,479)

Notes:

1. Formation expenses of HK$5,999 written off to the profit and loss account for the year ended 31 March 1989 were disallowed in the tax computation for 1988/89.

2. It was subsequently noted that the figure of HK$412,053 for the year of assessment 1993/94 should be a profit rather than a loss.

50. In its profits tax returns, Company G made certain tax adjustments, excluded the profits from the sale of units in Building R, excluded the gain of HK$1,200,000,000 from the loan waiver and declared the following profits or losses:

Year of assessment	**Profits/(Losses)**
	HK$
1988/89	(57,679,934)
1989/90	(4,430,032)
1990/91	11,064,626
1991/92	43,345,279
1992/93	28,189,746
1993/94	27,608,728
1994/95	(55,244,838)
1995/96	(52,176,795)
1996/97	(20,112,859)

51. In its 1996/97 profits tax return, Company G did not include as assessable profits the gain of HK$1,200,000,000 arising from the waiver of the loan principal under the Loan Agreement. Company G described the loan waiver in the following terms:

> ' The loan was provided by a financial institution for the sole purpose of financing the acquisition of the company' s investment property in 1988. The company was released to repay the principal amount of the loan in May 1996 and the loan was written back. Accordingly, the exceptional gain of HK$1,200 million is capital in nature and should be treated as non-taxable.'

Assessments

52. The Assistant Commissioner was of the opinion that the scheme or transactions described above was entered into by the above parties for the sole or dominant purpose of obtaining a tax benefit. On divers dates, profits tax assessments for the years 1988/89 to 1996/97 were raised on the appellant under section 61A(2) of the Ordinance as follows:

(a) Year of assessment 1988/89

	HK$
Loss per return	(732,124)
Add: Deferred expenditure	47,134,883
Assessable profits	46,402,759
Tax payable @17%	7,888,469

(b) Year of assessment 1989/90

	HK$
Loss per return	(802,654)
Add: Deferred expenditure	57,907,460
Assessable profits	57,104,806
Tax payable @16.5%	9,422,292

(c) Year of assessment 1990/91

	HK$
Loss per return	(845,985)
Add: Deferred expenditure	63,316,507
Assessable profits	62,470,522
Tax payable @16.5%	10,307,636

(d) Year of assessment 1991/92

	HK$
Loss per return	(841,039)
Add: Deferred expenditure	70,204,164

Assessable profits	69,363,125
Tax payable @16.5%	11,444,915

(e) Year of assessment 1992/93

	HK$
Loss per return	(823,084)
Add: Deferred expenditure	76,761,303
Assessable profits	75,938,219
Tax payable @17.5%	13,289,188

(f) Year of assessment 1993/94

	HK$
Loss per return	(412,053)
Add: Deferred expenditure	84,417,925
Assessable profits	84,005,872
Tax payable @17.5%	14,701,027

(g) Year of assessment 1994/95

	HK$
Loss per return	(814,240)
Add: Deferred expenditure	92,793,086
Assessable profits	91,978,846
Tax payable @16.5%	15,176,509

(h) Year of assessment 1995/96

	HK$
Loss per return	(1,258,533)
Add: Deferred expenditure	101,690,564
Assessable profits	100,432,031
Tax payable @16.5%	16,571,285

(i) Year of assessment 1996/97

	HK$
Loss per return	(636,479)
Add: Deferred expenditure	11,976,787
Assessable profits	11,340,308
Tax payable @16.5%	1,871,150

53. By six letters all dated 19 April 1995, two letters dated 11 November 1997 and a letter dated 5 March 1998, Messrs KPMG Peat Marwick, as tax representatives for the appellant, objected against the assessments.

54. By his Determination dated 12 August 1998, the CIR confirmed the profits tax assessments for the years of assessment 1988/89 to 1996/97 raised by the Assistant Commissioner under section 61A(2) of the Ordinance. In particular, the CIR was of the opinion that:

> ' ...the charging of the "deferred expenditure" in the accounts of [the appellant] is clearly part and parcel of a composite tax avoidance scheme entered into by the relevant persons to obtain a tax benefit. Thus I do not accept the claim that the deferred expenditure was incurred to produce any chargeable profits. I do not think that the conditions in section 16(1) are satisfied at all.'

Revised assessment

55. As there was an error in the profits tax computation of the appellant for the year 1993/94. The CIR has indicated that she is prepared to revise the assessment as follows:

Year of assessment 1993/94

	HK$
Profit per return	412,053
Add: Deferred expenditure	84,417,925
Assessable profits	84,829,978
Tax payable @17.5%	14,845,246

Appeal to the Board of Review

56. Messrs KPMG Peat Marwick sent a notice of appeal dated 12 September 1998 to the Clerk to the Board of Review under section 66(1) of the Ordinance against the Determination of the CIR dated 12 August 1998.

THE APPEAL HEARING

Grounds of appeal

57. The grounds of appeal in the notice dated 12 September 1998 are as follows:

> '1. The deferred expenditure totalling HK$606,202,680 for all the years concerned was incurred to produce interest income chargeable to profits tax and, therefore, is deductible under Section 16(1) of [the Ordinance].
>
> 2. The Commissioner was incorrect in concluding that Section 61A of [the Ordinance] applies in respect of the transactions entered into by [the appellant] and identified in the Commissioner' s Determination dated 12 August 1998; in

particular, no tax benefit accrued to [the appellant] as a result thereof and so it is not a relevant person for the purposes of the said Section.

3. Without prejudice to the foregoing, even if in the event a tax benefit did result from the said transactions (which is denied), the sole or dominant purpose of entering into those transactions was not to obtain such a benefit; accordingly, for this reason also, the Commissioner was incorrect in applying Section 61A of [the Ordinance] to the said transactions.

4. In view of the foregoing, the Commissioner's Determination confirming the profits tax assessments for the years of assessment 1988/89, 1989/90, 1990/91, 1991/92, 1992/93, 1994/95, 1995/96 and 1996/97 issued to [the appellant] and increasing the assessable profits of [the appellant] for the year of assessment 1993/94 to $84,829,978 with tax payable thereon of $14,825,246 should be cancelled and the tax position of [the appellant] should be revised as follows:

Year of assessment	Adjusted loss/(Assessable Profits) per [appellant] HK$	Adjusted loss carried forward per [appellant] HK$
1988/89	732,124	732,124
1989/90	802,654	1,534,778
1990/91	845,985	2,380,763
1991/92	841039	3,221,802
1992/93	823,084	4,044,886
1993/94	(412,053)	3,632,833
1994/95	814,240	4,447,073
1995/96	1,258,533	5,705,606
1996/97	636,479	6,342,085'

Representation & witnesses called

58. At the hearing of the appeal, the appellant was represented by Mr Barrie Barlow.

59. The respondent was represented by Mr Ambrose Ho, SC.

60. Mr Barrie Barlow called Mr A, Mr B and Mr D to give oral evidence. A statutory declaration of Mr E was taken as read.

61. Mr Ambrose Ho did not call any witness.

62. The appellant's case was that in early 1987, Company W, through its Mr AF, an associate, and Ms AG, an assistant vice president, touted a structure for the Group to obtain 'financing at a very low after tax cost of fund'. After some meetings, Mr B countersigned a letter dated 27 March 1987 from Company W confirming the Group's interest. A scheme, which was more elaborate than the one discussed at the early stages, was subsequently implemented.

Mr A's evidence

63. Mr A told us that he was the senior legal adviser of the Group from 1985 to late 1988. His evidence was that around May 1987, Mr B told him that Company W had approached him regarding the Group's interest in a refinancing scheme and asked him if he had any knowledge about financing structures with tax efficient features. He replied that he was unfamiliar with Hong Kong tax matters. Mr A asserted in evidence that 'medium term financing was not readily available to Hong Kong development and construction companies at the time'. From May 1987 to May 1988, he, Mr B and others were involved in the process of liaising with Company W and Company AV. One of the issues on which advice was sought was whether the refinancing scheme would fall within the then newly introduced section 61A of the Ordinance. He reviewed the various legal and accounting advices that were provided to the Group by Company W. He asserted that, in consultation with Mr B, the Group decided that it would be a prudent step to take independent legal advice in Hong Kong. Advice was obtained from Mr AH, QC [now a non-parmanent judge of the Court of Final Appeal]. He further asserted that:

> 'The legal and accounting advice confirmed that the scheme was a legitimate way to raise finance for the Group and that although it would save tax for the Group, it was not assessable under section 61A. As the Group's legal counsel and having reviewed the various professional advices given to the Group, I was aware of the uncertainty associated with the interpretation of section 61A at the time. However, all the advice of the legal and accounting experts on the structure and implementation of the Refinancing Scheme were favourable and the Group was comforted by the analysis of the professional advisers that the Refinancing Scheme was a legitimate exercise in raising finance for the Group.'

64. Under cross-examination, he said this on the nature of the beast to which he attributed favourable advices:

> 'Q Was there any aspect of those concerns that you raised with [Mr AI] which was met with an opinion that, yes, there was a concern here, there was a possibility that it may not in fact survive a challenge of section 61A?
>
> A I would assume so but I cannot really recall any specifics, but in the nature of senior tax counsel advising on sophisticated transactions, is that not inherent? They do not give you a 100 percent guarantee, you know, all clear. They

always give, and I have deal with counsel for years not on tax matters, but I have never had counsel give me a clean opinion on anything. That is the nature of the beast. Sorry. I think if counsel gave me ...

Q Do you remember any aspect ...?

A Sorry, if I could finish? I think if counsel gave me a 60 percent chance of success on something, I have done very well to get counsel to actually put a number on advice, but normally it is vague like that, but I would expect counsel to put in cautionary paragraphs from time to time in his opinion.

Q Was there any aspect of this advice that, say, was to the effect, for example, like it is quite probably that you would not survive a section 61A challenge?

A I appreciate you need to probe for details but I do not think that I am going to spontaneously suddenly remember details of these opinions seventeen years later. So my answer remains I really do not remember the specific details.'

65. His answer to the question whether the Group consulted Mr AH, QC, again after June 1987 was as follows:

'Chairman: I am sorry, may I just ask one question if you are moving onto a new topic. Did [the Group] go to [Mr AH] again for advice after June 1987 in respect of this scheme?

A I do not think so. I cannot recall a particular instance where we went back to [Mr AH] again, but we might have. I just do not recall.

Chairman: Is there any particular reason?

A We seem to be, there were quite a few advisors already involved in the later stages.'

66. Towards the end of his cross-examination, he was asked whether, compared with a 'conventional loan' the scheme did have an advantage in the sense that it would have saved the group's tax liability. His answers to this and other questions were as follows:

'A No the commercial driver here is more money for a longer period, and this came as an unsolicited proposal to the group. Looking at it commercially it made a lot of sense. I mean, there was a way to borrow more money for a longer tenure, and if the way to do that is in effect through tax-efficient planning, well, more power to you.

Q It made available more cash, as you earlier said, because the tax position of the group is reduced. The tax liability of the group is reduced.

A I think that is part of the transaction. Yes.

Q And that is one of the attractions?

A Yes.

Q And that is one of the attractions of the scheme.

A Sure.

Q Are you able to tell us this, that if it had not, if the scheme had not been able to achieve a tax advantage, would the group have considered this scheme feasible?

A I am really not the right person for that question. I think that is really for [Mr B] on the financing side. Because unlike him, I did not have access to some of the other ranges of alternatives, like the one you showed me yesterday, [Bank AJ] or some, the floating rate notes letter that you showed me yesterday.

Chairman: Sorry, [Mr A], [Bank V] was prepared to lend $600 million against the security of the building.

A [Bank V]?

Chairman: [Bank V], that was under the transaction [Bank V] would lend $600 million against the security of the building and rental. Now a much simpler way would be, instead of going through the scheme, would be for [Company F], the original owner, to mortgage or charge the building to [Bank V] and obtain a loan of $600 million on the same terms as [Bank V] granted to the appellant. And if [the Group] wanted to put it in, the building in the name of another subsidiary, it would be simpler in this case the [Company G], the [Company G] to borrow from [Bank V] $600 million against the security of the building, right?

A That would have been simpler?

Chairman: It would have been simpler, and less expensive in terms of transactional costs. Did that occur to you as an alternative?

A No, I do not recall it being discussed by us. I mean, it might have been one of the things that [Mr B] was weighing at this time, but I cannot speak to that.

Chairman: That would be conventional borrowing.

A I mean, my recollection is, as I have said, that conventional borrowing was a very limited option at the relevant time. It is a different circumstance than today and a different circumstance to ten years ago, and the tenure was a lot shorter and the valuation issues were going to be difficult.

Chairman: But [Bank V] was prepared to lend $600 million against the security of the building.

A In this transaction?

Chairman: Right. There is no other security.

A I think this is really a better question for [Mr B].'

Mr B's evidence

67. Mr B told us that he was the finance director of the Group from 1983 to 1991. His evidence was that in early 1987, he started active discussions with the Group's bankers on options available to re-finance Building R. He thought that maximising the leverage on the Group's major asset was probably their best way to raise funds for expansion. Several banks which had never had any dealings with the Group started to contact him with proposals. An unsolicited approach came from Company W which claimed expertise as a merchant banker in the business of originating and distributing loans and claimed that they had recently developed proposals that involved tax efficient term financing methods, having worked with specialist accountants and lawyers to develop proposals suitable for Hong Kong companies in the Group's position. After some discussions, Mr B countersigned the letter dated 27 March 1987. He led and coordinated the Group's consideration of the proposal, involving so-called debt defeasance structures, working with Mr A, and Ms AK, the Group's then company secretary and financial controller, and dealing directly with Company W and Company AV. He asserted that he believed it prudent for the Group to seek independent advice from Hong Kong solicitors and leading Hong Kong tax counsel. In May 1987, Messrs AL, solicitors, and Mr AH QC [now a non-permanent judge of the Court of Final Appeal]

were retained to advise on, among others, whether Company W's proposed scheme was within the scope of section 61 or section 61A of the Ordinance. The occupation permit for Building R was issued on 11 May 1987 and a 6-month extension was obtained to repay the Bank S syndicated loan by 11 February 1988 and a further 3-month extension was obtained to repay by 11 May 1988. After working with Company W and Company AV for three months, he prepared a memorandum dated 2 July 1987 to the board of Company K. We interpose here to note that:

(a) he stated in his memorandum marked 'CONFIDENTIAL' that the 'proposed scheme appears to be very viable (but then of course it is not entirely risk free) ... Since we shall be discussing a matter of serious consequences, I feel obliged to enclose all the relevant materials/reports for your information and consideration'; and

(b) the memorandum contained a hand-written note 'Please go to each director/or secretary/ in turn and get back this memo and all papers and give them to me with a checklist of names'.

Shortly afterwards, the board gave him approval in principle.

He proceeded to finalise matters with Company W and the proposals were implemented from 9 – 11 May 1988. He asserted that what he was looking to achieve in the refinancing of Building R was:

'(a) a medium terms loan for at least 7 – 8 years at market rates or better (in 1987 the HIBOR 6 month interest rate had fluctuated in one year from 2.75% p.a. – 7.93 p.a.) secured against [Building R] without other assets being encumbered;

(b) in an amount substantially exceeding the existing [Bank S syndicated] Loan debt (of HK$357 million) so that the surplus could be used to fund other projects; and

(c) which would not create any likely legal or accounting or taxation difficulties or dangers.'

He concluded his witness statement, adopted as his evidence-in-chief, by asserting that:

' I have absolutely no hesitation in saying that the driving consideration and primary purpose of [the Group] in adopting the [Company W] scheme was to raise medium term borrowings for [the Group] using its principal asset ([Building R] property) as security on the best achievable commercial terms available. We were advised by the best legal and accounting experts available that, although the scheme would

enable the Group to achieve savings in profits tax, it did not infringe section 61 and was not assessable under section 61A of the [4 lines of repetition left out] Inland Revenue Ordinance. Although the savings in profits tax was an incidental advantage of the scheme it was never our primary purpose in adopting the [Company W] proposals.'

68. Under cross-examination, he said that in the beginning of 1987, he started considering the refinancing of Building R; that he was talking to the banks in terms of a conventional mortgage loan; and that in March 1987 Company W came along. He was then cross-examined about the Bank V loan.

'Q When did negotiation with [Bank V] begin?

A I think it came in after we basically we have the financial structure in place. What I mean is that we have the financial, the, how shall I describe it, we have the, we have what we want to achieve. I mean the transaction, structure of the transaction agreed. Then we brought in the banks, yes.

Q You mean after the structure of the scheme was settled, then negotiation with [Bank V] began?

A I would think so.

Q That would have been when? After July?

A Oh, yes.

Q 1987. And would you not say that the [Bank V] loan basically was one of these very conventional loans?

A It was not.

Q Why was it not?

A Because it was not lending to the property owner. It was lending to [the appellant].

Q Yes, and is there anything else which is different from a conventional loan?

A And it was against the support of a mortgage, the support of a rental assignment, yes.

Q Well, those would have been standard features of a conventional loan, would it not, support of a mortgage on the property, support of the assignment of the rental income from the property? That would have been pretty standard.

A Yes.

Q So the only thing that is different between the [Bank V] loan and that of a standard, conventional loan would have been that you are advancing to an entity which is not a property owner. That is the only point, is it not?

A But I think when [Bank V] came in they were brought in together with [Company W].

Q Sorry?

A They were brought in to join [Company W] and ourselves brought them in as a lender.

Q Yes, I am talking about the features of this loan. How is that different from a conventional loan?

A Not much.'

69. We note that the Bank V loan was secured by:

(a) a joint and several guarantee by Company K and Group L;

(b) a first legal charge over Building R; and

(c) an assignment of all rental income.

70. Under the earlier simpler scheme, the amount of the gross loan was $900,000,000 and the amount of the net loan was $600,000,000. Under the more complicated scheme subsequently implemented, the amount of the gross loan was $1,200,000,000 [the Company X loan] and the amount of the net loan was $600,000,000 [the Bank V loan]. During his cross-examination, Mr B explained to us that the essence of the tax defeasance scheme was to turn the payment of principal of the net loan into something deductible and that the other element of the scheme was the liability assumption.

'Q Well, I am not talking about any individual company at the moment. I am just testing these general propositions to see if you agree with them.

Normally repayment on principal would not give you deductions in terms of tax. Section 16 simply does not apply to that sort of situation.

A Agreed.

Q But somehow if you can devise a scheme or a proposal or a structure which allows you to turn the payment of the principal into something deductible in terms of tax, that would be the sort of tax advantage that you would gain out of that scheme.

A I think you can say that is the essence of the tax efficient scheme or tax defeasance scheme.

Q That is the essence of the tax defeasance scheme, yes. I am jumping a little ahead here. That is the essence of this [simpler] proposal in order to generate a tax benefit of $108 million?

A Yes.

Q That is also the essence of the, later on, more complicated scheme that you eventually developed, the scheme that we are dealing with here now. That is also the essence of that scheme, is it not? If I may refer you to page 275 of the respondent' s bundle? Does that mean that you agree that is the essence of that more complicated scheme?

A Yes.

Q And hence this $108 million tax benefit that we see on page 56, really we are talking about turning a sum equivalent to $600 million into something that is deductible at eighteen percent, and that would give you a tax benefit of $108 million ...

A Yes.

Q ... if we can achieve that.

A Yes.

Q Can I ask you to look at page ...

Chairman: Sorry, let me make sure I understand what you are saying. When you say that the essence of the scheme is to derive a figure, which is repayment of principal, into expense item, right? Have I got it correct?

A Actually there are two elements to the scheme: one is the liability assumption. That is the capital gain, which is not taxable at the end of the day. And so in a way thank you for this chance of clarification because the question was asked, because there are two elements. There is also a liability assumption scheme.

Chairman: Back to understanding your earlier answer. Now, we are talking about savings on a $600 million. Are we talking about $600 million because $600 million is the net loan amount, not the inflated amount? The figures we are working with is 300.

A No, here we are working on a gross loan of $900, a net loan of $600.

Chairman: So the difference is $300.

A The savings is really on the net borrowings, not on the gross borrowings. I think I make that statement clear in the beginning.

Chairman: Yes.

A There is no saving on the gross loan. The gross loan carries interest, then there is this net loan.

Chairman: So there are two elements: the turning of the repayment of the principal of the net loan into an expense item ...

A Yes.

Chairman: ... and the other one is what?

A The other one is actually because we have a gross loan of $900 million, that will have to be liquidated with a payment of $300. But I think [Mr D] will be able to explain this a lot better than I am.'

71. Mr B was asked why Mr AH, QC, had not been consulted on the scheme which was in fact implemented. He initially attributed more expertise to Mr AI. He gave the following answers on the limited involvement of Mr AH:

'Q ... We have seen [Mr AH's] advice to you. We understand [Company W] has procured advice from [Mr AI]. Is there any reason why [Mr AH] was not again consulted on the scheme actually implemented?

A [Mr AI] was more a tax expert. I hope I am not being disrespectful ...

Q No, we just want the truth.

A ...to [Mr AH]. [Mr AI] is regarded as the top tax lawyer in the [Country AM], and he has written numerous tax books on the tax situation. And he advised [Company W] and he had dealt with a lot more tax cases, I think, than [Mr AH]. But to be doubly sure I want a legal QC at that time to give his opinion, so I want to play safe.

Q And that was the reason you went to [Mr AH] because you wanted the group to consult its own lawyers as to the viability of the scheme?

A Because this is a Hong Kong tax situation, then I want the top Hong Kong counsel for his opinion.

Q And having advised on the simpler scheme, when it came to the implementation of the more elaborate scheme, why did the group not then instruct its own lawyers to advise the group?

A I think on the implementation we were guided by [Mr AN] and [Mr AI] and [Company AV], so we felt that that was good enough.

Q You consulted [Mr AH] because the group wanted to be sure, wanted to take a prudent step, but when it actually came to the implementation of the scheme in question, the group did not instruct its own lawyers. What is the explanation?

A We got his opinion. We did not think that we would change anything major to the scheme, so we thought actually it is not necessary.

Q Sorry?

[A] We did not think it would change anything substantially compared to the simpler scheme.

Chairman: Sorry, I have difficulty following your answers. You said the group wanted to be, the group was prudent, conservative, and despite all the advices given by outside parties you wanted to get your own advice. You went to [Mr AH] because he was the top QC in Hong Kong and he was a member of this board. And in his note he concluded by saying that the vulnerability of the scheme to attack under section 61A becomes very real. Did you follow that up? If you want to look at it, it is at page 505 of your, of the appellant's bundle.

Mr Barlow: This was the intermediate advice, Mr Chairman, because he does go on.

A Attached to that is also the telephone conversation notes.

Chairman: So, is your answer that you were comforted by pages 506 and 507? You might like to read from page 504 to 7 before you give any answer, just to remind yourself.

A Yes.

Chairman: Have you finished? Can I ask you the question as to whether you thought it was necessary to follow up on his reservations?

A I think as I read this, he was talking about the definition of relevant person, whether it is a company or a group. I think I may be wrong on this, but on page 507 he seems to be saying that the relevant person should be a company rather than the [the Group].

Chairman: Thank you.'

Evidence on professional advices

72. Of the legal and professional advices attributed to professional advisers, only the following advices given by Mr AH, QC, were in evidence.

73. By letter dated 14 May 1987 (pages 488 – 489 of the appellant's bundle), Mr A wrote to Mr AO of Messrs AL. Mr A sought advice on a scheme said to be set forth in Company W's letter of 9 May 1987; referred to an opinion (which was not in evidence) of an unnamed leading counsel; and sought advice on whether the transfer by Company F to company 'A' was 'a taxable event' and whether 'the scheme viewed in its entirety [is] a reasonable use of tax planning or does it fall a [*sic*] foul of anti-avoidance legislation and practice'. Mr A had wanted to instruct Professor AP but he was out of Hong Kong until July. Mr A had discussed the possibility of

instructing Mr AQ or Mr AR, QC [now a Vice-President of the Court of Appeal]. Mr A impressed on Mr AO to 'minimize the number of copies made and the circulation of existing copies'.

74. By Instructions to Counsel dated 26 May 1987 (pages 490 – 491 of the appellant's bundle), Messrs AL instructed counsel who was not named to advise on the two issues which they were instructed by Mr A to advise on. Messrs AL impressed on counsel to treat the proposals with utmost confidentiality and to minimise the number of copies made and their circulation.

75. By an Opinion dated 3 June 1987 (pages 492 – 499 of the appellant's bundle), Mr AH, QC, opined on the second issue as follows:

> 'SECTION 61A OF THE INLAND REVENUE ORDINANCE
>
> 11. This is a new provision which empowers the Commissioner in the circumstances as outlined in subsection (1) of section 61A to assess a "relevant person" to tax as if the transactions which have been entered into had not been entered into or carried out.
>
> 12. This provision of law in Hong Kong only came into effect in March 1986. The wording of section 61A has not been tested in any court of law in Hong Kong. It is therefore difficult to anticipate how the provisions will be applied.
>
> 13. As far as the scheme under consideration is concerned, there could only be two "relevant persons": [Company F] and Company "A".
>
> 14. As far as [Company F] is concerned, it is difficult to see what "tax benefit" [Company F] could be said to have obtained as a result of the transaction. It has simply transferred its property at a price slightly below market value. Either the transaction comes within the provisions of section 14, or it does not. If it does not come within section 14, because the transaction can properly be regarded as the sale of a capital asset, I cannot see where there is room for the application of section 61A. If it is caught by section 14 because the transfer to Company "A" is a trading transaction, then the gain is taxable irrespective of section 61A.
>
> 15. As far as Company "A" is concerned, the fact that it entered into a transaction whereby it borrowed $900 million from [Company W] could hardly be denied. I cannot see how the Commissioner could, by the application of section 61A(2) assess Company "A" as if Company "A" had only borrowed $600 million from [Company W] and therefore allow only the interest on $600 million to be charged against its assessable profits. If Company "A" incurred any liability at

all to [Company W], then it must be to the whole tune of $900 million. As far as I am aware [Company AS] is not a party related to [Company W].

CONCLUSION

16. Whilst there can be no certainty in these matters, I am reasonably confident that the disposal of [Building R] by [Company F] will be treated as the sale of a capital asset, and that the scheme as a whole will not fall foul of current anti-avoidance legislation and practice in Hong Kong.'

76. A telephone note dated 4 June 1987 (pages 501 – 502 of the appellant's bundle) made by Mr AO made the following note of his telephone discussion with Mr AH, QC.

'As to the second point, I referred to Section 61A, and in particular:-

(a) there was clearly a "tax benefit" to Company "A";

(b) the definition of "transaction" included a "scheme" so that the individual parts of the Scheme would not necessarily have to be looked at in isolation;

(c) it was possible that one or more of the parties involved in the scheme other than Company "A" would have done so "for the sole or dominant purpose of enabling the relevant person (Company "A") ... to obtain a tax benefit";

(d) the scheme may have "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" (sub-Clause 61A(1)(f)) In that context, I referred to the investment made by [Company F] of HK$300 million and the subsequent payments of the same amount by one or more companies who would receive no benefit from their investments or payments. In that context, Counsel referred to the Charterbridge case as demonstrating that payments by a company which is a member of a group, for the benefit of other members of the same group, are less closely looked at than payments to unconnected parties. The important point was that the roles of the participants in the scheme should be lawful and within their powers;

(e) a corporation or corporations resident or carrying on business outside Hong Kong would participate in the Scheme (Sub-section (g) of Section 61A(1));

(f) in circumstances where the Revenue came to the conclusion under Section 61A(1) that one of the participants' sole or dominant motives was to enable Company "A" to obtain a tax benefit, why would the Revenue, in order to be

> able to counteract the tax benefit to Company "A", have to find that the loan to Company "A" was less than HK$900 million (as Counsel' s view appeared to be) when, under Section 61A(2)(b) the Revenue was able to assess Company "A"' s liability to tax "in such other manner as to the Assistant Commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained". It seemed to me that the purpose of the Section, unlike Section 61, was to make it unnecessary for the Revenue to prove that the part of the Scheme which gave rise to the obligation to pay interest was itself artificial or fictitious so as to enable it, or some part of it, to be disregarded, provided that the conclusion could be drawn under Section 61A(1) that one of the parties to some other part of the Scheme had entered into it for the sole or dominant purpose of enabling Company "A" to obtain a tax benefit. Counsel' s view on this was that the revenue would need to show, which it could not (subject to the actual documentation used to evidence the loan being adequate and subject also to possible problems if the [Company AS] was associated with [Bank U]) that less than HK$900 million had been loaned to Company "A" or (presumably) that less than HK$900 million remained owning (*sic*) from Company "A" throughout the period that interest continued to be paid. This would be the case whether the Revenue sought to exercise its powers under Sub-Section (a) or (b) of Section 61A(2). Counsel said that he would be happy to respond to further instructions on these points should we wish to send them to him.
>
> Counsel agreed that however well the documentation was put together, the Revenue, if it chose to question the transaction, would be entitled to production of all relevant documentation, including correspondence with [Bank U], from which it would be apparent that the whole scheme emanated from [Bank U] – not critical in itself but obviously raising suspicions.'

77. By a Note dated 26 June 1987 (pages 503 – 505 of the appellant' s bundle), Mr AH QC, referred to further instructions dated 24 June 1987 (which was not in evidence) and continued as follows:

> '2. Paragraph 1 of the Further Instructions deals with the question of "tax benefit" to Company "A". Looking at the position of Company "A" as the borrower of the $900 million, I cannot see how it could be argued that the deduction of interest from its assessable income under section 16(1)(a) could be said to be a "tax benefit" for the purposes of section 61A. To this extent, I agree with the views expressed by [Company AV]. However, it is possible to regard the [Group of Companies] as "the relevant person" for the purposes of section 61A(1), because the definition of "person" in section 2 of the ordinance includes "a corporation, partnership, trustee, whether incorporated or

unincorporated, or body of persons". To the extent that I said, in paragraph 13 of my previous Opinion, that there could only be two "relevant persons" ([Company F] and Company "A") I now feel that I was wrong: that view was too retricted (*sic*).

3. If the Commissioner could quite legitimately ask himself the question whether the [Group of Companies] has obtained a "tax benefit" on account of the scheme, the answer might well be Yes.

4. To a very large extent, the question would depend upon whether, in reality, looking at the position globally, $900 million have been lent – or only $600 million. The answer to this question would depend upon a close analysis of [Company AS]: its constitution, its normal activities and, above all, its relationship with [Company W].

5. If one looked at the position globally, then many of the circumstances in section 61A(i) could well apply: in "form and substance" the transaction has resulted in the property being held by one wholly owned company in [the Group] (Company "A") rather than another wholly owned subsidiary ([Company F]).

6. As to whether there has been "any change in the financial position" of the group (being ' the relevant person') resulting from the scheme, this will depend upon the actions of [Company AS] upon receiving the $300 million. If, for example, [Company AS] were to partially discharge Company "A"' s debt so that, at the end of the day, Company "A" is relieved of the obligation to repay $900 million, then a substantial "tax benefit" would have been obtained by [the Group]. One of the companies in the group – Company "A" – would have enjoyed tax deductions on a loan of $900 million over a period of 8 years, but, upon the expiration of 8 years, its obligation is not to repay $900 million but something substantially less.

7. Moreover, as my instructing solicitors also pointed out in the course of our telephone conversation on 4 June 1987, the use of Company C, and the unnusual (*sic*) transaction to be entered into by Company C (paying the $300 million to [Company AS] with no apparent benefit to itself) might well bring in the provisions of (f) and (g) of section 61A(i) as well.

8. Once it is admissible that one should regard [the Group] as "the relevant person" rather than Company "A", then the vulnerability of the scheme to attack under section 61A becomes very real.'

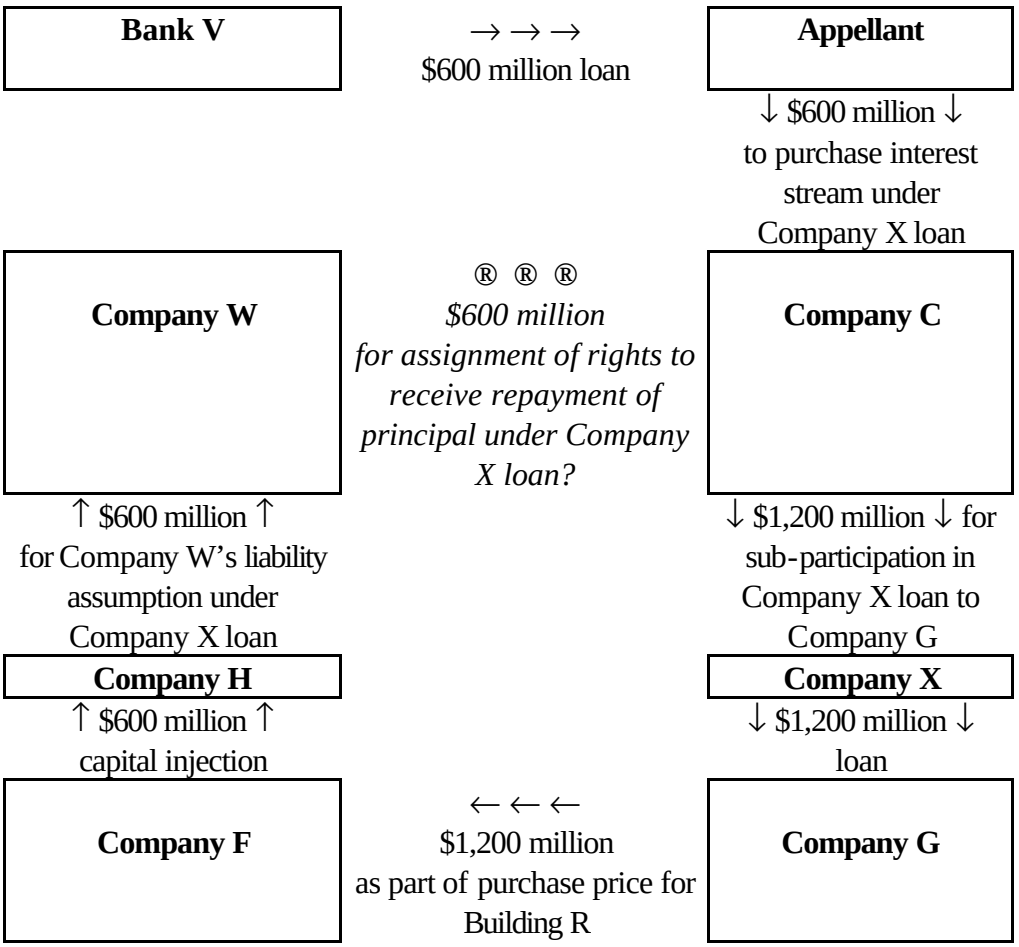
78. By a 'Note of telephone conversation' dated 26 June 1987 (pages 506 – 507 of the appellant's bundle), Mr AH, QC, made a record of his conversation with Mr AO:

> 'My Note of today's date does not address this issue: Assuming that the Commissioner comes to the view that [the Group] (being the "relevant person" for the purposes of subsection (1) of Section 61A) has derived a tax benefit from a tax avoidance scheme; having regard to the various considerations mentioned in paragraphs (a) to (g) of that subsection, how is he to give effect to his powers under subsection 2(2)?
>
> Subsection (2) confers wide powers upon the Assistant Commissioner to "assess the liability to tax of the relevant person": paragraph (b) of subsection (2) empowers the Assistant Commissioner to assess in such manner as he considers appropriate "to counteract the tax benefit which would otherwise be obtained".
>
> Upon my analysis of the position, as set out in my Note, there is in reality a mis-match between subsections (1) and (2). Generally speaking, the process of assessment under Part X of the Inland Revenue Ordinance relates to the liability of individual companies, irrespective of whether group accounts are prepared or not for accounting purposes. The Assessor, under Part X of the Inland Revenue Ordinance, cannot issue a Notice of Assessment to a group. Subsection (2) of Section 61A says that the powers conferred upon an assessor under Part X are to be exercised under subsection (2) by an assistant commissioner: these powers must, on the face of it, relate to the liability of individual companies.
>
> But, on the facts of this case, it is difficult to see how the Assistant Commissioner could assess Company "A" to tax by disregarding the $900 million loan when Company "A" is not the "relevant person" – the "relevant person" being [the Group].
>
> Whilst, therefore, the Scheme might be open to attack under Section 61A(1) on account of the factors mentioned in my Note, by treating [the Group] as the "relevant person", I find it difficult to see how the Commissioner could exercise any effective powers under subsection (2). This also casts doubt on the basic proposition that a group could be a "relevant person" for the purposes of subsection (1).'

Company C's source of funds

79. When Mr Barrie Barlow opened the case for the appellant, it was not clear to us how Company C sourced its funds for another $600,000,000 in addition to the $600,000,000 it

received from the appellant, in order to fund the $1,200,000,000 participation in the loan to Company G. The following diagram explains the question:



80. Mr Barrie Barlow told us in his opening that the most probable inference was that Company W used the money for Company H.

> 'Professor Harvey: Mr Chairman, may I ask a question for clarification? With respect to the flow of funds, the taxpayer has $600 million flowing into [Company C]. [Company C] has $1.2 billion flowing into [Company X]. Where is the additional $600 million generated, just so I can note this on the chart, within [Company C]? What is the source of that funds?
>
> Mr Barlow: [Company C] is a subsidiary of the [Company W] group. So I think the short answer, so far as we are concerned, is that it is [Company W] money, but if you look at the diagram it is a fact that [Company W] received payment of $600 million, and that the liability assumption ...

Professor Harvey: Right, on the far [right] of the chart, correct?

Mr Barlow: Exactly.

Professor Harvey: And I am looking for the input analysis of how we moved from $600 to $1.2. Should I add an arrow coming down from [Company W] into [Company C] for another $600 million? Is that correct?

Mr Barlow: Well, I think my learned friend is going to suggest that it is, but so far as that aspect of the matter is concerned ...

Professor Harvey: I only ask this because, as you brought it up, it is real money. We could trace cheques or money transfers, etc, so I wanted to know where did that money, where was it generated?

Mr Barlow: I am not, there are two letters dealing with this from Company AT who, I think, were the liquidators of the relevant [Company W] company. Bear in mind, Professor, [Company W] of course disappeared from the scene. Much of it was closed. The residue was actually taken over by [Bank AU] and largely for that reason we will not have any witnesses from [Company W] who were involved in the devising of the scheme and the implementation. The closest we get is the kind assistance of [Mr D], who I suppose is the next best thing because he was the tax partner in [Company AV], as they were then called, who was advising [Company W]. But the two letters from [Company AT] certainly draw the conclusion that the [Company W] obligation was probably met from the $600 million paid under the liability assumption agreement by [Company H], and it is a reasonable assumption to make. I do not dispute that.

Professor Harvey: No, I am just curious and I wanted to tie up the details.

Mr Barlow: We do not have any direct evidence, Professor, as to, if you like, the money going from one account into another account and then on.

Professor Harvey: Correct, undoubtedly if [Company W] is repaid at the end it must have been the source.

Mr Barlow: I think it is reasonable to infer that an investment banking group would not enter into transactions of this kind and leave themselves uncovered. And so we were not, in fact that assumption is also made by one of our witnesses, [Mr B], in his witness statement. He feels now that he - I will deal with this when he gives his evidence - but he feels now that he may have jumped to an assumption that he should not necessarily have. He does not regard himself in any shape or form as an expert on the scheme. Of course [Mr D] is, and I think the question might usefully be raised with him. I believe that his answer will probably be that it is [Company W] money. They were investment bankers. Of course they would not leave themselves exposed, and therefore the most probable inference is that they used the money for [Company H].'

81. By fax dated 6 May 1988, Mr AF of Company W sent Ms AK a Status Report and a revised Completion Memorandum (pages 94 – 99 of the Revenue' s Bundle):

(a) The Status Report (pages 95 – 96) reported that each of the appellant, Company G, Company F, Company H, Company C, Company X had opened bank accounts with Company W in Hong Kong 'subject to very restrictive operating rules and [Company W had] prepared irrevocable and unconditional instructions regarding each and every transaction to be effected in respect of the same'. There is no mention of any account of Company W with Company W (see paragraph 30(2) above on the reference to Company W's account with Company W).

(b) An 'Assignment of Principal Agreement between [Company C] and [Company W]' was listed as an outstanding matter 'to be dealt with before the Completion Date' [that is, 11 May 1988] (page 96).

(c) The following chart appeared on pages 98 – 99:

'(IV) <u>Cash Flow</u>

The payments/cash flow required to carry out the Scheme will appear in the books of [Company W] as follows:-

		Dr. HK$m	Cr. HK$m
1	Cash	242	
	[The appellant]		242

	(Drawdown of Syndicated Loan)		
2	[Company X]	1,200	
	[Company G]		1,200
	(Loan to [Company G])		
3	[Company G]	1,200	
	[Company F]		1,200
	(Settlement of Purchase Consideration for Property)		
4	[Company F]	600	
	[Company H]		600
	(Capitalisation of Offshore Sub.)		
5	[Company F]	358	
	[The appellant]		358
	(Repayment of Intercompany Loan from [the appellant])		
6	[Company H]	600	
	[Company W] – [Company AS]		600
	(Funding of [Company AS] payment)		
7	[Company C]	1,200	
	[Company X]		1,200
	(Sub-participation of Loan)		
8	[The appellant]	600	
	[Company C]		600
	(Assignment of Interest Stream)		
9	[The appellant]	242	
	Cash		242
	(Disbursement of Balance of Syndicated Loan)'		

Significantly there is no debit entry for Company W and there is no credit entry for the remaining $600,000,000 for Company C, in addition to the $600,000,000 credit entry from the appellant.

82. By letter dated 1 March 1995 (page 285 of the Board's Bundle), Company AT advised the assessor on behalf of Company C that Company C obtained $600,000,000 from Company W (written exactly as in the original):

> ' We refer to your letter dated 19 January 1995 issued to our abovenamed client and on behalf of our client advised that [Company C], after entering into the Sub-Participation Agreement with [Company X], assigned its rights under Clause 2.04 of the Sub-Participation Agreement to [Company W] and [the appellant] respectively. As a result of such assignments, [Company C] obtained HK$600 millions from [Company W] and HK$600 millions from [the appellant] and applied them in financing the payment of HK$1,200 millions to [Company X] pursuant to the Sub-Participation Agreement dated 9 May 1988.
>
> We hope the above information satisfies your enquiry and regret that it is not provided to you within 21 days as requested in your letter dated 19 January 1995.

> We advise that our client did not intend to delay the submission of the above information. Taking into consideration that all events were happened in 1988 and our client needed extra time to extract the requested information from old files in storage (as explained in our letter dated 13 February 1995) and the holidays of the Chinese New Year in early February, we request on our client's behalf to have the compound penalty issued on 17 February 1995 duly waived.'

83. By letter dated 24 March 1995 (page 286 of the Board's Bundle), Company AT replied to the assessor on behalf of Company C that the effective date of the assignment by Company W to Company C should be 11 May 1988:

> '1. Due to a long lapse of time, our client is unable to locate the original copy of the Deed of Assignment of Rights between [Company C] and [Company W] from the old files in storage.
>
> 2. Based on the information available to our client, the effective date should be May 11, 1988 and the rights assigned were all of the rights, of [Company C] to receive from [Company X] amounts under the Sub-Participation Agreement between [Company X] and [Company C] in respect of amounts received or applied by [Company X], in or towards satisfaction of [Company G's] obligations to repay the principal amount of the advance (i.e. HK$1,200,000,000) under the Loan Agreement between [Company G] and [Company X].'

84. In paragraph 37 of his witness statement, Mr B asserted that Company C raised $1,200,000,000 from two sources, $600,000,000 from the appellant, funded by the Bank V loan, and $600,000,000 from Company H, funded by a capital issue of shares to Company F. In his evidence-in-chief, Mr B volunteered a correction and told us that Company C raised the money from Company W:

> 'Q In paragraph 37 you describe in one paragraph the scheme as you understand it. Is that a fair description of what you have written there?
>
> A Well, on hearing the presentation and discussion last night I think I may have jumped into the wrong conclusion in one part.
>
> Q Which part is that?
>
> A [Company C], which is a [Bank U] company, [Company W] company, raising money, $600 million from [Company H]. It was not entirely correct. I think they raised the money from the [Bank U], not from borrowing.

Chairman: So [Company H] should read [Bank U]?

A Yes, it should be a [Bank U], I think. It should be [Bank U] – Asia because it is their subsidiary. But [Company H] has entered into a sub-participation agreement, right, with [Bank U], so it is not directly with [Company C]. I think, if I can be ...

Chairman: I see, so can I just have the name? I just want to see which one you are replacing it with.

A Could I have a chart that was shown to the Board yesterday about the, I mean this chart would do, the chart that was given by the Revenue.

Mr Barlow: Do you mean annex A to my opening address?

A Yes, the chart that you gave yesterday on the loan and cash flow.

Q This is annex A to my opening address, Mr Chairman. Is that the document you are referring to?

A Yes, [Company H] gave the $600 million to [Company W]. It is stated here, so [Company H] did not give the money to [Company C].

Chairman: So, are you saying that [Company C] got this part of it from [Bank U]?

A They got it from [Bank U]. They got it from [Bank U] – Asia.

Chairman: Is it [Bank U] or [Bank U] – Asia?

Mr Ho: [Bank U] Co. I do not think that is disputed.

Mr Barlow: No.

A That is [Bank U] Co, yes, OK, this is the chart from the Revenue.'

85. One day later, Mr B claimed that he did not know the arrangement between Company W and Company C:

'Chairman: [Mr B], do you know how [Company C] sourced its funds for $1,200 million?

[Mr B]: [Company C] is the subsidiary of [Bank U] Co. As far as I am concerned -- as far as I know, [Company H] has paid $600 million liability assumption to [Bank U] Co and I would not have known the arrangement between [Bank U] Co and [Company C]. That is not in my area. That is not for me to know.'

86. Mr B was referred to the letter dated 1 March 1988 at page 285 of the Board's Bundle and he told us that he had no reason to doubt that Company C received $600,000,000 from Company W:

'Mr Ho: Right, now there is this [Company Y], that is [Company C] -- is common ground, there is no issue on this – [Company C], after entering the sub-participation agreement, assigned the rights under clause 204 to [Company W] and [the appellant] respectively, and then as a result of such assignment, [Company C] obtained $600 million from [Bank U] and $600 million from [the appellant].

Now, it is stated there [Company C] obtained $600 million from [Bank U]. Now, is there any reason for you to think that that might not have been an accurate reflection of the true position, any reason to suspect that that was not the case?

Mr Barlow: One question at a time, please.

[Mr B]: Now, you ask me whether this -- whether I can -- I should have any doubt on [Company C] receiving $600 million from [Bank U]?

Mr Ho: Yes.

[Mr B]: I -- this is what it says here.

Mr Ho: No reason to doubt its accuracy?

[Mr B]: No.'

87. In answer to questions from Mr Barrie Barlow, Mr B claimed that whatever happened was between Company W and Company C:

'Mr Barlow: Yes, just answer the questions I am putting to you, [Mr B].

Can I take you back to the Commissioner's bundle, this one (indicating), at page 96, and you were asked about item 1(f),

assignment of principal agreement between [Company C] and [Bank U] Co. Now, you were asked whether there is any reason to believe that that was not carried out and, again, my question is: do you have any personal knowledge one way or the other?

[Mr B]: I do not.

Mr Barlow: If you turn on two pages, page 98, the middle of the page:

"Cash flow. The payments/cash flow required to carry out the Scheme will appear in the books of [Company W] as follows."

Now, you are a financial man, [Mr B], can you look through the entries under that sub-heading and tell us if there is any entry in relation to any assignment from [Company C] to [Company W], in the books of [Company W]?

[Mr B]: There is no transaction like that.

Mr Barlow: And what does that tell you?

[Mr B]: It is whatever happens is between [Company C] and [Bank U] Co.'

88. Under cross-examination, Mr B agreed that the steps in respect of the 'gross loan' went round in a circle and there was no real gain or loss:

'Mr Ho: All that goes round in a circle, does it not? [Company H] paid $600 million at the discount rate to procure an income of $1.2 billion in eight years time. That $600 million goes to [Company C]. [Company C] then pays $1.2 billion to [Company X] so as to enable [Company X] to advance the so-called "gross loan" to the group? All those steps go round in a circle. Is that correct?

[Mr B]: Yes, if that is your interpretation.

Mr Ho: Well, I am not -- it is not my interpretation. I am asking you whether you would agree with that.

[Mr B]: Yes.

Mr Ho: And of this circle there is really no gain or loss by any of those entities involved? No real gain or real loss? Is that not right?

[Mr B]: Is that a question?

Mr Ho: Yes. Is that not right?

[Mr B]: Yes.'

Mr D's evidence

89. Mr D told us that he was a senior tax partner in Company AV – Hong Kong, formerly known as Company AV.

90. He said that that he had little independent recollection of the details of the transactions; that Company AV was brought in by Company W; that in early 1987, he met representatives of the Group and in mid-1987, after the main proposals had been prepared by Company W, he took over responsibility for providing opinions on Hong Kong tax issues that arose and for arranging any other advice that would be required; and that once the scheme's accounting and taxation implications had been explained and counsel's opinions reviewed, there was no further input from Company AV of any significance.

91. In his evidence-in-chief, he criticised the item '$600 million for asserted assignment of principal' from Company W to Company C in the Revenue's chart:

'[Mr D]: ... probably the most disturbing thing for me is the line at the top, this "$600 million for asserted assignment of principal."

Now, certainly, as far as I can recollect – and I was not aware of this – and just to give some sort of credibility to that statement, ourselves and [the Group] in about a year afterwards, in 1989, orchestrated a supplemental deed of covenant between [Company H], [Company C] and [Company X] because we were concerned as to whether [Company H] could enforce [Company C] to release [Company G] from its obligation under the loan. Now, I do not see how [Company C] could have entered into that agreement if it had actually assigned its obligations to another party.'

92. Under cross-examination, Mr D said that Company AV were brought in by Company W; that Company W were the arranger and that how Company W sourced the funds was not a matter of concern to him. He went on to amend his answer:

'[Mr D]: Sorry, can I just amend that slightly? It would have been a concern – it would have been a concern to us if we had felt that [Company C] was being technically funded by [Company H], this loop existed. When I say that it was not a concern to us, [Company C] was required to find its own funding to suit its own obligations and to us, when we looked at this, [Company C], although it is part of the [Bank U] group, it is a separate, independent, legal person in its own right, and we would look at [Company C] as an independent, legal entity.

...

Mr Ho: If you had been aware that [Company H] was to – the funds from [Company H] was to channel through [Bank U] back to [Company C], that would have undermined the integrity of the parties involved in this transaction, is that what you are saying?

[Mr D]: Yes, I would have – I would have strongly advised that that should not have happened.

...

Mr Ho: Yes, and what is the objection? What is the essence of your objection?

[Mr D]: I mean, to me, I mean the essence of that is then there is clearly, as in your diagram, tries to portray a secured artificial flow of funds.'

Statutory declaration of Mr E

93. Mr E declared in his statutory declaration that he was the chairman of the ultimate holding company of the appellant; that Company W approached the Group proposing a refinancing scheme; that the details were dealt with by Mr B; that Mr B reported his conclusions to the Group board in July 1987 and that the package was implemented in May 1988.

Authorities

94. The appellant furnished us with a bundle of the following authorities:

(a) Inland Revenue Ordinance, Chapter 112
(b) Yick Fung Estates Ltd v CIR [1998] 4 HKC 700 (HC)
(c) Yick Fung Estates Ltd v CIR [2000] 1 HKC 588 (CA)
(d) WP Keighery Pty Ltd v FCT [1956-1957] 100 CLR 66
(e) Newton v Commissioner of Taxation [1958] AC 450

(f) Mangin v IRC [1971] AC 739
(g) CIR v Swire Pacific Ltd [1979] HKLR 612
(h) Ure v FCT [1981] 11 ATR 484
(i) CIR v Challenge Corporation [1987] 1 AC 155.
(j) FCT v Peabody [1993-1994] 181 CLR 359
(k) CIR v Cosmotron Manufacturing Co Ltd [1997] 2 HKC 417
(l) Hitch v Stone (Inspector of Taxes) [1999] STC 431
(m) O' Neil v CIR [2001] 1 WLR 1212
(n) IRD Departmental Interpretation and Practice Notes No 15 (Revised) dated September 1992.
(o) Eastern Nitrogen Ltd v Commissioner of Taxation (2001) 108 FCR 27
(p) Hart and Another v Commissioner of Taxation 196 ALR 636
(q) Income Tax Assessment Act 1936

95. The respondent furnished us with a bundle of the following authorities:

(a) Inland Revenue Ordinance, Chapter 112
(b) Yick Fung Estates Ltd v CIR [2000] 1 HKC 588 (CA)
(c) Cheung Wah Keung v CIR [2002] 3 HKLRD 773 (CA)
(d) D44/92, IRBRD, vol 7, 324
(e) Pettigrew v FCT (1990) 92 ALR 261 (Fed Ct of Aust – Full Ct)
(f) FCT v Spotless Services Ltd (1996) 34 ATR 183 (HC of Aust)
(g) FCT v Consolidated Press Holdings and Ors (2001) 47 ATR 229 (HC of Aust)
(h) Vincent v FCT (2002) 50 ATR 20 (Fed Ct of Aust – Single Judge)
(i) Vincent v FCT (2002) 51 ATR 18 (Fed Ct of Aust – Full Ct)
(j) FCT v Myer Emporium Ltd (1987) 163 CLR 199 (HC of Aust)
(k) CIR v Wattie [1998] STC 1160 (PC)
(l) Sun Newspapers Ltd v FCT (1938) 61 CLR 337 (HC of Aust)
(m) Wharf Properties Ltd v CIR 4 HKTC 310 (HC/CA/PC)
(n) Henriksen v Grafton Hotel Ltd [1942] 24 TC 453 (CA)
(o) Atherton v British Insulated and Helsby Cables Ltd [1926] AC 205 (HL)
(p) Regent Oil Co Ltd v Strick [1966] AC 295 (HL)

BOARD'S DECISION ON WHETHER DEDUCTIBLE UNDER SECTIONS 16(1) AND 17(1)(C)

The deferred expenditure

96. $600,000,000 was the consideration paid by the appellant under the Assignment referred to in paragraph 22 above in exchange for Company C's assignment of all its right to receive amounts under the Sub-Participation Agreement in respect of the amounts received and

applied by Company X in or towards satisfaction of Company G's obligations to pay interest on the principal amount of the advance under the Sub-Participation Agreement.

97. The deferred expenditure totalled $606,202,680 (see paragraph 57 above). According to the appellant's financial statements, $600,000,000 represented the consideration and $6,202,680 represented legal and professional fees paid in respect thereof (see paragraphs 43 and 45 above).

The parties' contentions

98. Mr Ambrose Ho contended that the deferred expenditure was not deductible under sections 16(1) and 17(1)(c).

99. Mr Barrie Barlow contended that section 61A was a charging provision; that the sections 16 and 17 point did not arise because all the assessments were expressly section 61A assessments and that it was an agreed fact (see paragraph 52 above) that the assessments were raised on the appellant under section 61A(2).

Whether parties entitled to raise point

100. In our decision, whether the deferred expenditure was deductible under section 16(1) was raised by the appellant itself in its first ground of appeal. All that the respondent was doing was arguing against it.

101. In contrast, the contention of Mr Barrie Barlow advanced at the hearing of the appeal was not covered by the grounds of appeal. Thus, such contention was not open to the appellant by reason of section 66(3).

102. Before we consider whether the deferred expenditure was deductible, we shall deal first with Mr Barrie Barlow's contention in case we are wrong on the point that such contention was not open to him.

Whether section 61A a charging section

103. Section 5 is the charging provision for property tax.

104. Section 8 is the charging provision for salaries tax.

105. Section 14 is the charging provision for profits tax.

106. Section 61A is not a charging provision at all.

107. Part X is the part on assessments. To assess is to set the value of a tax at a specified level and an assessment sets the value of a tax at a specified level.

108. Section 59 is the primary provision in Part X. It provides that:

> *'Every person who is in the opinion of an assessor chargeable with tax under [the Ordinance] shall be assessed by him as soon as may be after the expiration of the time limited by the notice requiring him to furnish a return under section 51(1)'.*

A person must be chargeable with tax under the Ordinance before that person may be assessed by an assessor.

109. The proviso to section 59 deals with the situation where a person is about to leave Hong Kong. Sub-sections (2) & (3) empower the assessor to make estimated assessments. Sub-section (4) deals with the situation where accounts of a trade or business have not been kept in a satisfactory form.

110. Section 60 empowers an assessor to assess or make additional assessments within six years (or 10 years in case of fraud or wilful evasion) where it appears to an assessor that for any year of assessment any person chargeable with tax has not been assessed or has been assessed at less than the proper amount.

111. What happens when a transaction is caught by section 61A(1) is governed by sub-section (2) which provides that *'where subsection (1) applies, the powers conferred upon an assessor under Part X shall be exercised by an assistant commissioner ...'* Since all powers conferred upon an assessor by the Ordinance may be exercised by an assistant commissioner under section 3(4), the effect of section 61A(2) is to remove the power of an assessor to assess under Part X in section 61A cases and restrict the exercise of such power to the assistant commissioner level. In the exercise by the assistant commissioner of the power to assess under Part X, the assistant commissioner *'may ... assess the liability to tax of the relevant person (a) as if the transaction or any part thereof had not been entered into or carried out; or (b) in such other manner as the assistant commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained.'* This is clearly in the context of setting the value of tax. Section 61A is an aid to the charging provisions.

Duty of the Commissioner to determine afresh the proper assessment

112. It was an agreed fact that the assessments were raised under section 61A(2). The appellant objected against these assessments. We are bound by authorities to hold that the duty of the respondent in considering the objection was to act *de novo*, and to determine afresh what

should be the proper assessment. We are bound by authorities to reject Mr Barrie Barlow's contention.

113. In Mok Tsze Fung v CIR [1962] HKLR 258 at pages 274 – 275, Mills-Owens J said that the Commissioner's duty was to act *de novo* and determine afresh what the proper assessment should be:

> *'A consideration of the functions of the Commissioner and the Board of Review may not be out of place. Although the Ordinance expresses the proceedings before the Commissioner to be an "appeal", what he is required to do by section 64 is to "review and revise" the assessment in pursuance of the taxpayer's notice of objection .... His duty is to review and revise the assessment and this, in my view, requires him to perform an original and administrative, not an appellate and judicial, function of considering what the proper assessment should be. He acts de novo, putting himself in the place of the assessor, and forms, as it were, a second opinion in substitution for the opinion of the assessor. He determines what should be the proper assessment afresh rather than acts as a judge weighing the merits of competing cases presented to him and making a determination within the limits or confines of the contest.'*

114. Section 64 was amended by Ordinance No 35 of 1965. Blair-Kerr J held in CIR v The Hong Kong Bottlers Ltd [1970] HKLR 581 that Mok Tsze Fung v CIR was not affected by the amendment. In that case, the taxpayer claimed depreciation allowances on plant and machinery and balancing allowance on an industrial building. The assessor allowed the claim for depreciation allowance in full but disallowed the balancing allowance claim. The taxpayer objected. The Commissioner upheld the assessor's decision on the balancing allowance and determined that no depreciation allowance should have been allowed. The majority of the Board of Review held that the Commissioner acted ultra vires in reopening the assessment with respect to the depreciation allowances. The Commissioner appealed by way of case stated and the primary question was 'whether the Board was correct in ruling that the Commissioner had acted *ultra vires* in re-opening the assessment with respect to the allowances on plant and machinery'. Blair-Kerr J answered that question in the negative and said at pages 590 – 591 that:

> *'The question is simply this : Is a taxpayer entitled to limit the jurisdiction of the Commissioner to consider an assessment by the terms of his notice of objection ? In my view the answer to that question is, clearly, "no" Admittedly, the foundation of the Commissioner's jurisdiction under s. 64(2) is the receipt by him of a valid notice of objection; and a notice of objection must be stated precisely in order to give the Commissioner jurisdiction to consider the assessment at all, that his jurisdiction is circumscribed by the grounds as framed by the taxpayer. Once the Commissioner is seized of the matter, his*

first duty is, of course, to consider questions raised by the notice of objection; but it is the assessment he is concerned with. I do not agree with the majority opinion of the Board of Review that "the words 'the assessment objected to' are governed by the notice of objection". The assessment objected to is the assessment, not part of the assessment or such aspects of the assessment as the taxpayer chooses to have considered. One can readily visualize cases in which it would be utterly impossible for the Commissioner to consider one aspect of an assessment to the exclusion of other aspects. His duty is to consider the assessment made by the Assessor, and to consider it as a whole. Having done so, his powers are not confined to confirming, reducing, or annulling the assessment. The subsection states specifically that he may increase it; and, clearly, the Commissioner's power to increase an assessment is not limited to cases in which the taxpayer, by his notice of objection, may, for any reason, seek to have his assessment increased. If the taxpayer's submission in this case were well founded, it would mean that in every case in which the Commissioner considered that an assessment should be increased, his duty would be to direct his Assessor to raise an additional assessment under s. 60. He would, himself, be powerless to increase the assessment, although s. 64(2) says that he may do so.

The Assessors' jurisdiction under s. 60 is more extensive in point of time than that of the Commissioner; and it does not depend upon any initiating process, such as the lodging of a notice of objection. But, the jurisdiction conferred by s. 60 upon the Assessor does not affect the Commissioner's jurisdiction under s. 64(2) to consider assessments, already made and confirmed, which he is required to consider upon the filing of a valid notice of objection. In my view, the decisions in the ***Mok and Herald International Ltd.*** *cases were not affected in the slightest by the amendments to s. 64 which were effected by ordinance No. 35 of 1965. In redrafting s. 64, it would appear that the intention was simply to give legislative effect to judicial criticism of the phraseology which had been employed in the section as originally enacted.*

I would, therefore, answer the first question posed by the Board of Review in the negative.'

115. In CIR v D H Howe [1977] HKLR 436 at pages 443 – 444, Cons J expressed the *obiter* view that:

'Two further questions remain. They are no longer in point because of the conclusions I have just expressed. But in courtesy to the arguments put before me I should say something.

> *For the first it is necessary to return to section 61. This commences with the words "Where an assessor is of opinion that any transaction" etc. In the present instance no assessor has at any time been of that opinion. It was first formed by an Assistant Commissioner acting for the Commissioner under section 3(3) in considering the taxpayer's original objection. It was later endorsed by the Commissioner himself. Has there then been a valid application of section 61? Section 3(4) provides that: "All powers conferred upon an assessor by this Ordinance may be exercised by an assistant commissioner". It is argued that an "opinion" is not a "power". Strictly speaking that may be so. But it is equally possible to regard the formation of the opinion as an integral part of the power to disregard. However there is a less technical way to approach the question. It was first adopted some time ago by Mills-Owens, J. in* ***Mok Tsze-fung v. The Commissioner of Inland Revenue.*** *At the foot of p. 274 he said:-*
>
> *"His (i.e. Commissioner's) duty is to review and revise the assessment and this, in my view. requires him to perform an original and administrative, not an appellate and judicial, function of considering what the proper assessment should be. He acts de novo, putting himself in the place of the assessor, and forms, as it were, a second opinion in substitution for the opinion of the assessor. He determines what should be the proper assessment afresh rather than acts as a judge weighing the merits of competing cases presented to him and making a determination within the limits or confines of the contest.".*
>
> *At that date the Ordinance provided for an "appeal" to the Commissioner in the first instance rather than an "objection". And the Commissioner's duties on the appeal were to "review and revise the assessment" rather than to "confirm, reduce, increase or annul" it. The present wording was introduced in 1965, possibly as the result of that decision. However, the "Objects and Reasons" annexed to the appropriate Bill indicate that the Legislature intended no change in the nature of the Commissioner's functions. And I agree respectfully with the opinion of Blair-Kerr, J. that it has not effected any:* ***The Commissioner of Inland Revenue v. The Hong Kong Bottlers Ltd.'.*** *When taken as a whole the effect of section 64(2) is to require the Commissioner to reconsider the assessment and if necessary to reassess it from the very beginning.'*

116. The respondent determined that the deferred expenditure was not deductible. The appellant challenged that by its first ground of appeal. We must now decide whether it was deductible.

The law

117. Section 16(1) provides that:

> *'(1) In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period ...'*

118. Section 17(1)(c) provides that:

> *'(1) For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of –*
>
> . . .
>
> *(c) any expenditure of a capital nature or any loss or withdrawal of capital ...'*

119. Wharf Properties Limited v Commissioner of Inland Revenue [1997] AC 505 was an appeal to the Privy Council from Hong Kong. We refer to the report in Appeal Cases because this is the proper citation of authorities and because the reference in the Tax Cases report to relevant passages in the judgment of the Court of Appeal is incorrect. Interest was the expense in issue.

120. Delivering the judgment of the Privy Council, Lord Hoffman said at page 510 that:

> *' Prima facie, therefore, the interest was deductible under section 16(1)(a). It was incurred for the purpose of earning taxable profits in future years: compare Commissioner of Inland Revenue v. Swire Pacific Ltd. [1979] 1 H.K.T.C. 1145. But section 17 contains a list of various kinds of expenditure in respect of which "no deduction shall be allowed." Their Lordships think that in the absence of express contrary language, expenditure which comes within section 16 will not be deductible if it falls within one of the prohibited categories in section 17. Since sections 16 and 17 together "provide exhaustively for the deduction side of the account which is to yield the assessable profits" (Commissioner of Inland Revenue v. Mutual Investment Co. Ltd. [1967] 1 A.C. 587, 598), section 17 would serve no purpose if it did not exclude deductions which would otherwise be allowed under section 16. Some of the heads of deduction in section 16 expressly say that they are to*

apply notwithstanding anything in section 17, but section 16(1)(a) is not one of them.

The relevant head of prohibition in section 17 is subsection (1)(c): there shall be no deduction of "any expenditure of a capital nature." The question therefore is whether the interest payments were expenditure of a capital nature. In thus adopting a criterion of deductibility which refers to the "nature" of the payment—either capital or revenue—the statute is adopting an accounting concept as a rule of law: see Dixon J. in Hallstroms Pty. Ltd. v. Federal Commissioner of Taxation (1946) 72 C.L.R. 634, 646. But whereas the application of the concept by accountants is often a debatable question on which professional opinions may differ, the law is obliged to give a decisive answer. Expenditure is either of a capital nature or it is not, and whether it is one or the other is a question of law: see Beauchamp v. F. W. Woolworth Plc. [1990] 1 A.C. 478 and the cases cited by Lord Templeman, at pp. 491-492.

There are many cases in which different forms of words have been used to try to illuminate the distinction in terms appropriate to the particular and often complicated facts of the case. But the present case seems to their Lordships to be relatively straightforward, in which it is sufficient to say that the cost of "creating, acquiring or enlarging the permanent . . . structure of which the income is to be the produce or fruit" is of a capital nature, while "the cost of earning that income itself or performing the income-earning operations" is a revenue expense: see per Viscount Radcliffe in Commissioner of Taxes v. Nchanga Consolidated Copper Mines Ltd. [1964] A.C. 948, 960. Applying this distinction, it seems to their Lordships to be plain that the payments of interest during the years in question were made for a capital purpose, namely, as consideration for the use of the money which enabled Wharf to acquire the tramway depot and hold it pending its conversion by redevelopment into an income earning capital asset.'

At page 513, their Lordships approved various passages in the judgment of Litton VP (Mr Henry Litton QC had by then been appointed as a Vice-president of the Court of Appeal):

'*It remains only for their Lordships to make certain observations upon the judgments in the Court of Appeal and some of the authorities to which they were referred. Their Lordships are entirely in agreement with the judgment of Litton V.-P. [1995] 2 H.K.L.R. 522, 554-564, and in particular his observation, at p. 562, that to say that the interest payments secured the use of the bank's money was unhelpful; it is necessary to inquire into the purpose of the loan.'*

121. In the Court of Appeal, [1995] 2 HKLR 552 at page 563, Litton VP concluded as follows:

> *'Conclusion*
>
> *The conclusions I have reached are these:*
>
> *(i) The words "outgoings and expenses" in the context of s. 16(1) are wide enough to encompass expenditure of a capital nature.*
>
> *(ii) Interest paid on money borrowed for the purpose of acquiring a redevelopment site (intended ultimately to generate rental income) is expenditure of a capital nature and therefore disallowed as a deduction under s. 17(1)(c).*
>
> *(iii) When the redevelopment is complete and is ready to generate chargeable income, or is actually generating chargeable income, any interest paid to secure that asset is expenditure of a revenue nature and is deductible if the conditions in sub-s. (2) of s. 16 are satisfied.'*

122. The Privy Council decided the Wharf case by applying Viscount Radcliffe's distinction in Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd [1964] AC 948 that the cost of 'creating, acquiring or enlarging the permanent . . . structure of which the income is to be the produce or fruit' is of a capital nature, while 'the cost of earning that income itself or performing the income-earning operations' is a revenue expense. At page 960 – 961, Viscount Radcliffe said:

> ' Again, courts have stressed the importance of observing a demarcation between the cost of creating, acquiring or enlarging the permanent (which does not mean perpetual) structure of which the income is to be the produce or fruit and the cost of earning that income itself or performing the income-earning operations. Probably this is as illuminating a line of distinction as the law by itself is likely to achieve, but the reality of the distinction, it must be admitted, does not become the easier to maintain as tax systems in different countries allow more and more kinds of capital expenditure to be charged against profits by way of allowances for depreciation, and by so doing recognise that at any rate the exhaustion of fixed capital is an operating cost. Even so, the functions of business are capable of great complexity and the line of demarcation is sometimes difficult indeed to draw and leads to distinctions of some subtlety between profit that is made "out of" assets and profit that is made "upon" assets or "with" assets. It does not settle the question, for instance, to say merely that an expenditure has been made to acquire a "source of income, as the appellant says here, unless one is clear that some forms of circulating

> capital itself, e.g., labour, raw material, stock-in-trade, are not themselves to be regarded as such a source.
>
> With these considerations in mind their Lordships must address themselves to Nchanga's challenged expenditure. It bought one right only, the right to have Bancroft out of production for 12 months. While, no doubt, money paid to acquire a business or to shut a business down for good or to acquire some contractual right to last for years may well be capital expenditure, it seems a contradiction in terms to speak of what Nchanga thus acquired, which exhausted itself and was created to exhaust itself within the 12 months' period within which profits are ascertained, as constituting an enduring benefit or as an accretion to the capital or income-earning structure of the business. If the expenditure is to be treated as capital expenditure at all, it cannot be for any reason such as that.'

Decision on deductibility

123. Applying these principles, what the appellant acquired was a contractual right to last for years and the cost of acquiring the permanent structure of which the income was to be the produce or fruit was of a capital nature. Thus, the consideration, together with the related legal and professional fees, paid by the appellant was not deductible.

Conclusion

124. The appeal fails.

125. With the exception of the assessment for the year of assessment 1993/94, all the assessments appealed against as confirmed by the Commissioner should be confirmed.

126. In respect of the assessment for the year of assessment 1993/94, it should be increased to show assessable profits of $84,829,978, with tax payable thereon of $14,845,246 (see paragraph 55 above).

BOARD'S DECISION ON APPLICATION OF SECTION 61A

Introduction

127. In view of our decision that the consideration, together with the related legal and professional fees, paid by the appellant was not deductible, the section 61A point does not arise and there is no need for us to deal with it.

128. However, in deference to the submissions made on behalf of the parties and in case we are wrong on the sections 16(1) and 17(1)(c) point, we deal with the section 61A point below on the footing that, contrary to our decision, the deferred expenditure was deductible.

Section 61A

129. Section 61A provides that:

> *'(1) This section shall apply where any transaction has been entered into or effected after the commencement of the Inland Revenue (Amendment) Ordinance 1986 (7 of 1986) (other than a transaction in pursuance of a legally enforceable obligation incurred prior to such commencement) and that transaction has, or would have had but for this section, the effect of conferring a tax benefit on a person (in this section referred to as "the relevant person"), and, having regard to-*
>
> *(a) the manner in which the transaction was entered into or carried out;*
>
> *(b) the form and substance of the transaction;*
>
> *(c) the result in relation to the operation of this Ordinance that, but for this section, would have been achieved by the transaction;*
>
> *(d) any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result, from the transaction;*
>
> *(e) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant person, being a change that has resulted or may reasonably be expected to result from the transaction;*
>
> *(f) whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm's length under a transaction of the kind in question; and*
>
> *(g) the participation in the transaction of a corporation resident or carrying on business outside Hong Kong,*
>
> *it would be concluded that the person, or one of the persons, who entered into or carried out the transaction, did so for the sole or dominant*

purpose of enabling the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit.

(2) Where subsection (1) applies, the powers conferred upon an assessor under Part X shall be exercised by an assistant commissioner, and such assistant commissioner shall, without derogation from the powers which he may exercise under that Part, assess the liability to tax of the relevant person-

(a) as if the transaction or any part thereof had not been entered into or carried out; or

(b) in such other manner as the assistant commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained.

(3) In this section-

"tax benefit" means the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof;

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

The 'transaction'

130. The first task is to identify the 'transaction'. Mr Ambrose Ho submitted that it was the scheme as a whole with its component parts collectively, which consisted of the undertaking and implementation of all the steps and matters set out in paragraphs 15 – 26, 31 – 34, and 39 – 40 above; the assignment by Company C to Company W of the rights to receive repayment of the principal under the Company X loan; the payment by Company W to Company C of $600,000,000; and the release of the repayment of the principal under the Company X loan ('the Scheme').

Two disputed steps

131. Two steps identified by Mr Ambrose Ho as constituting the Scheme, that is to say:

(a) the assignment by Company C to Company W of the rights to receive repayment of the principal under the Company X loan; and

(b) the payment by Company W to Company C of $600,000,000;

were disputed by the appellant.

132. We must resolve these factual issues.

133. The inherent probabilities are that Company C assigned to Company W the rights to receive repayment of the principal under the Company X loan and that Company W paid $600,000,000 to Company C. Mr Barrie Barlow told us in his opening that Company W:

> ' would not enter into transactions of this kind and leave themselves uncovered ... Of course they would not leave themselves exposed, and therefore the most probable inference is that they used the money for [Company H]', see paragraph 80 above.

134. Under the Deed of Covenant (see paragraph 26 above), Company H paid Company W $600,000,000 in return for Company W' s assumption of liability to pay the principal under the Company X loan of $1,200,000,000. Unless Company W' s position was covered by having an assignment by Company C to Company W of the rights to receive repayment of the principal under the Company X loan, Company W would be exposed and would have to repay the $1,200,000,000 principal under the Company X loan. It is inherently improbable for Company W to have touted a scheme which would expose itself to liability under the liability assumption. In this context, it should be borne in mind that Company C was not wholly owned by Company W. Company W indirectly held Bank U Asia to the extent of 50% of its shareholding and Bank U Asia wholly owned Company C, see paragraph 41 above.

135. If there was in fact no assignment by Company C to Company W of the rights to receive repayment of the principal under the Company X loan and if in fact Company W did not pay Company C $600,000,000, the inherent probabilities are that Company W would have made it a point to tell the Group and the appellant would have made it a point to lead evidence on the point. There is no evidence to support any suggestion that the appellant has lost any material witness. All we have from such witnesses as the appellant chose to call was the evasive and unhelpful statement by Mr B that 'it is whatever happens is between [Company C] and [Bank U] Co.', see paragraph 87 above. We do not for one moment accept that Mr B would have failed to satisfy himself on how Company C sourced the remaining $600,000,000 to fund the $1,200,000,000 participation in the loan to Company G.

136. The revised Completion Memorandum dated 6 May 1988 from Mr AF of Company W (see paragraph 81(b) above) was a contemporaneous document which was plainly supportive of the existence of the assignment by Company C to Company W. If Company W had subsequently found any better source of funds than what Mr D described as 'a secured artificial flow of funds' (see paragraph 92 above), the inherent probabilities are that Company W would have told the Group about it and the appellant would have led evidence on such source of funds.

Mr Barrie Barlow sought to rely on the absence of such item in the cash flow statement, see paragraph 87 above. This does not assist the appellant because there is no mention of Company W's account with Company W (see paragraph 81(a) above) and the cash flow statement is incomplete in that there is no debit entry for Company W and there is no credit entry for the remaining $600,000,000 for Company C, in addition to the $600,000,000 credit entry from the appellant (see paragraph 81(c) above). In any event, it is incumbent on the appellant to satisfy us why the clear and unequivocal statement referred to in paragraph 81(b) above did not mean what it said.

137. The letter dated 1 March 1995 from Company AT written on behalf of Company C advised the assessor of the existence of the disputed assignment and of the payment of $600,000,000 by Company W to Company C, see paragraph 82 above. Mr B told us under oath that he had no reason to doubt that Company C received $600,000,000 from Company W, see paragraph 86 above. We agree. We also have no reason to doubt that Company C received $600,000,000 from Company W. As Company C was only 50% owned by Company W, it is inherently improbable that Company W would have paid Company C $600,000,000 without consideration. There is no suggestion of any consideration other than the disputed assignment.

138. The letter dated 24 March 1995 from Company AT referred to in paragraph 83 above supported the existence of the disputed assignment.

139. Mr B volunteered a correction of his witness statement and told us that Company C raised $600,000,000 from Company W, see paragraph 84 above. We attach no weight to what he said in an attempt to backtrack.

140. The letter dated 21 September 1989 from Bank U Asia to Company H does not assist the appellant on these factual issues. Bank U Asia was not a party to any of the transactions referred to in the diagram in paragraph 79 above. What Bank U Asia undertook in this letter was that Company C should remain Bank U Asia's subsidiary and if Company C should cease to be its subsidiary, it would procure that all right and interest of Company C in the Sub-Participation Agreement be assigned to another of Bank U Asia's subsidiaries. No attempt has been made to argue how this letter could be said to be inconsistent with the existence of the disputed assignment.

141. The supplemental deed dated 22 September 1989 entered into by Company W, Company H, and Company C referred to in paragraph 37 above does not assist the appellant on these factual issues. By this supplemental deed, Company C undertook that it should, as and when directed by Company H, use all reasonable endeavours to procure that the instructions given to Company X pursuant to clause 5.01 of the Sub-Participation Agreement were carried out by Company X. Clause 5.01 of the Sub-Participation Agreement provided that Company X agreed with Company C that Company X, upon written instructions from Company C unconditionally and irrevocably release Company G from its obligation to repay $1,200,000,000. No attempt has been made to explain why Company W was made a party or to argue how this letter could be said

to be inconsistent with the existence of an assignment by Company C to Company W of the rights to receive repayment of the principal under the Company X loan.

142. We conclude and find as facts that:

(a) there was an assignment by Company C to Company W of the rights to receive repayment of the principal under the Company X loan; and

(b) Company W paid Company C $600,000,000.

Tax benefit for the relevant person

143. Mr Ambrose Ho submitted that the appellant was the relevant person.

144. We must now decide if there was a benefit on the appellant. As Rogers JA (as he then was) said in Yick Fung Estates Limited v CIR 2000 1 HKLRD 381 at page 399, unless there was a tax benefit, section 61A would not be relevant or the subject matter of consideration.

145. 'Tax benefit' was defined in sub-section (3) to mean the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof. A reduction in the amount of tax constitutes tax benefit for the purpose of section 61A. There is no requirement of any pre-existing liability or circumstances to tax, see Cheung Wah Keung v CIR [2002] 3 HKLRD 773 at paragraphs 47 and 48.

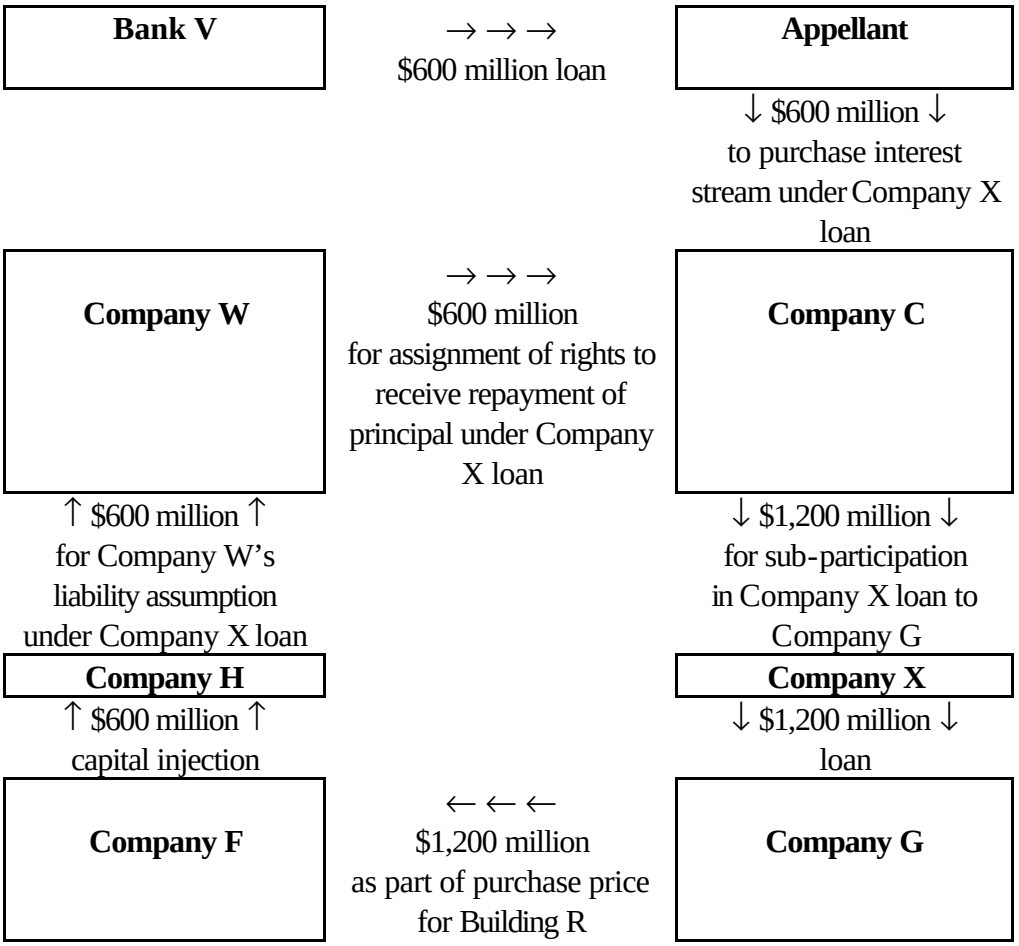
146. On the footing that (contrary to our decision) the deferred expenditure was deductible, the Scheme had, or would have had but for section 61A, the effect of conferring a tax benefit (in the sense of a reduction in the amount of tax) on the appellant.

147. Before we leave the question of tax benefit, we would comment briefly on the great play which the appellant made of the fact the Ordinance contains no provisions for group assessments. With respect this is a cursory and superficial approach. One must consider the tax position of each relevant individual company in the group before one can arrive at the conclusion that there is a tax benefit for the group. We have already concluded that there was a tax benefit for the appellant, and this is what matters for the purpose of section 61A. The phrase 'either alone or in conjunction with other persons' in section 61A(1) makes it clear that whether or not there is a tax benefit for some other person or persons is irrelevant, so long as the appellant obtains a tax benefit.

Fund flow on implementation of the Scheme

148. We would like to deal with fund flow on implementation of the Scheme and fund flow according to the Scheme before we consider the 7 matters in section 61A(1).

149. In view of our findings that there was an assignment by Company C to Company W of the rights to receive repayment of the principal under the Company X loan and that Company W paid Company C $600,000,000, the question mark in the diagram in paragraph 79 above should now be removed and the diagram is as follows:



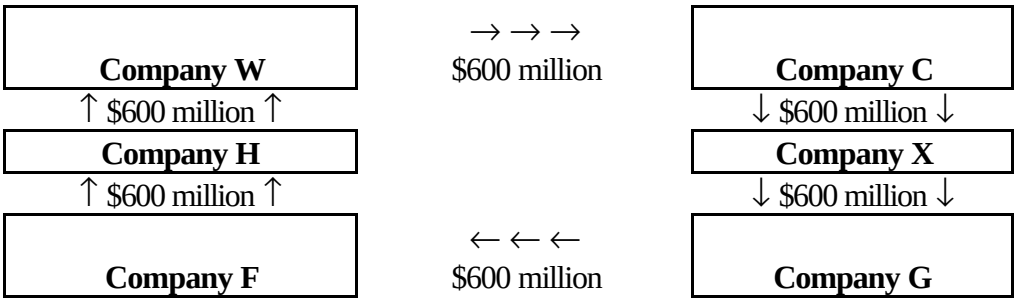
150. It will be seen from the diagram above that the Bank V loan was the source of $600,000,000. This $600,000,000 ended up in Company F. The Bank V loan fund flow was dealt with in greater detail in the agreed facts. Two cashier orders were issued under the Bank V loan, one in the sum of $358,223,214 in favour of Bank S and another in the sum of $241,776,786 in favour of Company W (see paragraph 16 above). They were used by the appellant to pay Company C for the purchase of the interest stream under the Company X loan (see paragraphs 29 and 33 above).

(a) $358,223,214 was used by Company C in discharge of Company F's indebtedness to Bank S. Company F repaid Company C by transferring $358,223,214, being part of the $600,000,000 plus $600,000,000 received on completion of the sale of Building R, from Company F's account with Company W to Company C's account with Company W (see paragraph 28

above). Thus, $358,223,214 of the $600 Bank V loan was used to discharge Company F's indebtedness to Bank S.

(b) The instructions from Company F to Company W referred to in paragraph 28 above left out $241,776,786 unaccounted for (there is a $1 or $6 discrepancy in respect of the $600,000,000 injection of capital into Company H, see paragraphs 28(2) and 30 above, but nothing turns on this discrepancy). We infer from paragraph 36 above that the remaining $241,776,786 went to Company K in discharge of the balance due by Company F to Company K. Company K's application of $241,776,786 is particularised in paragraph 36 above.

151. Removing the flow of the $600 Bank V loan from the diagram, it will be seen that there is a circular flow of $600,000,000 on implementation of the Scheme, as shown below:



152. In this circular fund flow, every participant relied on its payer as its source of funds for payment to its payee (see for example, paragraphs 27 – 30 above) and this went round in a circle. Mr D aptly described it as an 'artificial flow of funds' (see paragraph 92 above).

Fund flow according to the Scheme

153. The net effect is that Company G funded both the appellant's repayment of principal under the Bank V loan and the appellant's payment of interest under the Bank V loan.

(a) Under the Loan Agreement, Company G had to pay interest on the Company X loan of $1,200,000,000 at a fixed rate of 9.375% per annum (see paragraph 18 above). As the appellant had purchased the interest stream under the Company X loan (see paragraphs 21 and 22 above), Company G had to pay interest on $1,200,000,000 at a fixed rate of 9.375% per annum to the appellant.

(b) Under the Swap Agreement, Bank U Asia had to pay Company G 9.375% per annum on $1,200,000,000 and Company G had to pay Bank U Asia a floating rate amount arrived at by applying HIBOR plus a margin to a diminishing

'notional principal' of HK$600,000,000 and a 'principal installment', see paragraph 24 above.

(c) Under the Supplemental Swap Agreement, the appellant replaced Bank U Asia under the Swap Agreement, see paragraph 25 above.

(d) The net effect of the Swap Agreement and Supplemental Swap Agreement was that the appellant had to pay Company G 9.375% per annum on $1,200,000,000 and Company G had to pay the appellant a floating rate amount arrived at by applying HIBOR plus a margin to a diminishing 'notional principal' of HK$600,000,000 and a 'principal installment'.

(e) The liability of the appellant to pay Company G 9.375% per annum on $1,200,000,000 under the Swap Agreement and the Supplemental Swap Agreement is cancelled out by Company G's liability to pay interest on $1,200,000,000 at a fixed rate of 9.375% per annum under the Company X loan in respect of which the appellant had purchased the interest stream.

(f) The net effect of these steps is that there was a net fund flow from Company G to the appellant of a floating rate amount arrived at by applying HIBOR plus a margin to a diminishing 'notional principal' of HK$600,000,000 and a 'principal installment'. The floating rate amount was equal to the appellant's:

(i) repayment of principal under the Bank V loan; and

(ii) payment of interest under the Bank V loan.

The 7 matters

154. On the basis that there was a tax benefit, the various matters at (a) to (g) in section 61A(1) have to be considered to see if it would be concluded that the person, or one of the persons, who entered into or carried out the transaction, did so for the sole or dominant purpose of enabling the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit.

> '*Clearly, what must happen is that those matters must be considered and the strength or otherwise of the various resulting conclusions from considering those matters must be looked at globally. On the basis of that assessment, it must be decided whether the sole or dominant purpose was the obtaining of a tax benefit. It may be observed, for example, that one or other of the matters in (a) to (g) may be strongly or weakly suggestive of a purpose of obtaining a tax benefit or may be strongly or weakly suggestive of some other purpose. The Assistant Commissioner who undertakes such task has to use his own*

> *common sense and apply the results of his deliberations in respect of each matter and come to an overall conclusion',* per Rogers JA in Yick Fung Estates Limited v CIR 2000 1 HKLRD 382 at page 399.
>
> '*The Board approached the matter on the basis that the word "form" related to the legal effect or, as I would put it, the legal nature of the transaction and that the substance related to the practical or commercial end result of the transaction. In that respect, I would have no cause to disagree with the way in which this was put',* per Rogers JA in Yick Fung Estates Limited v CIR 2000 1 HKLRD 382 at page 400.

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

155. We are not impressed by any of the appellant's witnesses.

156. If the driving consideration and primary purpose of the Group in adopting the Scheme was to raise medium term borrowings for the Group using its principal asset (the Building R property) as security on the best achievable commercial terms available and if what Mr B was looking to achieve in the refinancing of Building R was:

> '(a) a medium terms loan for at least 7 – 8 years at market rates or better (in 1987 the HIBOR 6 month interest rate had fluctuated in one year from 2.75% p.a. – 7.93 p.a.) secured against the [Building R] without other assets being encumbered;
>
> (b) in an amount substantially exceeding the existing [Bank S syndicated] Loan debt (of HK$357 million) so that the surplus could be used to fund other projects; and
>
> (c) which would not create any likely legal or accounting or taxation difficulties or dangers (see paragraph 67 above);

then all he had to do was to arrange a loan of $600,000,000 from Bank V to Company F on the same terms as the Bank V loan under the Scheme, and with the same security, that is, a joint and several guarantee by Company K and Group L, a first legal charge over Building R and an assignment of all rental income. The transactional costs would have been much cheaper.

157. Yet the companies in the Group chose to enter into the Scheme, a dubious scheme with an artificial circular flow of $600,000,000 on implementation of the Scheme, made possible by Company W's role as banker. We are baffled by Company X's involvement in this case. No innocuous reason was suggested for Company X's grant of a $1,200,000,000 loan to Company G, with the back-to-back Sub-Participation Agreement with Company C. Why did Company C not

grant a $1,200,000,000 loan directly to Company G? It would be simpler but then it would be easier to see through the scheme. We are also baffled by Bank U Asia's involvement in this case. It entered into both the Swap Agreement and the Supplemental Swap Agreement simultaneously. The net effect under these two agreements was that there would be a net fund flow from Company G to the appellant equal to the appellant's repayment of principal under the Bank V loan and payment of interest under the Bank V loan. Why did Company G not contract directly with the appellant? Again, it would be simpler but, again, it would be easier to see through the scheme of channeling rental income from the property owning company to the appellant and then reducing the appellant's tax by deducting the deferred expenditure as an expense.

158. The manner in which the transaction was entered into and carried out was strongly suggestive that:

(a) the appellant, and

(b) the other participants in the Scheme,

entered into or carried out the Scheme for the dominant purpose of enabling the appellant to obtain a tax benefit.

The form and substance of the transaction

159. The form of the transaction is summarised in paragraphs 15 – 26, 31 – 34, 39 – 40 and 131 above.

160. The practical or commercial end result was that:

(a) the $600,000,000 Bank V loan was used to discharge Company F's indebtedness to Bank S and to discharge the balance due by Company F to Company K and Company K's application of funds is particularised in paragraph 36 above;

(b) Company G, the new owner of Building R and the recipient of rental income, made net monthly payments to the appellant in an amount equal to the appellant's repayment of principal under the Bank V loan and payment of interest under the Bank V loan;

(c) the appellant, the recipient of net monthly payments by Company G, incurred the deferred expenditure which was a tax deductible expense;

(d) Company F made a capital gain on sale of Building R to Company G;

(e) by simultaneously entering into the Loan Agreement and the Sub-Participation Agreement, Company X practically disappeared from the scene on implementation of the Scheme;

(f) by simultaneously entering into the Sub-Participation Agreement, the Assignment of the interest stream to the appellant and the assignment of rights to receive repayment of principal under the Company X loan, Company C had no role to play except, when called upon to do so by Company H, to release Company G from the obligation to repay the principal;

(g) by simultaneously entering into the Deed of Covenant and the assignment to Company C, Company W disappeared from the scene on implementation of the Scheme;

(h) by simultaneously entering into the Swap Agreement and the Supplemental Swap Agreement, Bank U Asia disappeared from scene on implementation of the Scheme; and

(i) by simultaneously entering into the Deed of Covenant and having a $600,000,000 injection of capital, Company H disappeared from the scene on implementation of the Scheme.

161. The form and substance of the transaction was strongly suggestive that:

(a) the appellant, and

(b) the other participants in the Scheme,

entered into or carried out the Scheme for the dominant purpose of enabling the appellant to obtain a tax benefit.

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

162. Company F made a capital gain on sale of Building R. Capital gain is not taxable. Company F ceased to receive any rental income.

163. Company G acquired Building R as a capital asset and Building R qualified for annual rebuilding allowance. More importantly, it received rental income which was taxable. However, the net monthly payments to the appellant in an amount equal to the appellant's repayment of principal under the Bank V loan and payment of interest under the Bank V loan were deductible expenses. The release from repayment of the Company X loan principal was a capital gain.

164. The appellant received net monthly payments from Company G. The deferred expenditure was a tax deductible expense from the taxable income.

165. Company H did not derive any taxable income.

166. This matter was strongly suggestive that:

(a) the appellant, and

(b) the other participants in the Scheme,

entered into or carried out the Scheme for the dominant purpose of enabling the appellant to obtain a tax benefit.

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

167. Since the appellant was incorporated shortly before the implementation of the Scheme, it is not meaningful to discuss any change.

Any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant person, being a change that has resulted or may reasonably be expected to result from the transaction

168. Both Company G and Company H were incorporated shortly before the implementation of the Scheme. It is not meaningful to discuss any change in relation to them.

169. Company F made a capital gain on sale of Building R. It paid off its indebtedness to Bank S and discharged its balance due to Company K. It injected $600,000,000 capital into Company H and ceased to receive any rental income.

170. Apart from receiving its fee, Company X had no change in financial position.

171. Company C had no change in financial position.

172. Apart from receiving its fee, Company W had no change in financial position.

173. Apart from receiving its fee, Bank U Asia had no change in financial position.

174. This matter was strongly suggestive that:

(a) the appellant, and

(b) the other participants in the Scheme,

entered into or carried out the Scheme for the dominant purpose of enabling the appellant to obtain a tax benefit.

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

175. All the non-group companies dropped out or practically dropped out on implementation of the Scheme. They cheerfully took part in an artificial circular flow of funds and most of them received their fees. The group companies would not have merrily paid the non-group companies their fees unless the Company W led companies satisfied the group companies of the tax benefit for the appellant and other relevant group companies.

176. This matter was strongly suggestive that:

(a) the appellant, and

(b) the other participants in the Scheme,

entered into or carried out the Scheme for the dominant purpose of enabling the appellant to obtain a tax benefit.

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

177. If, as the appellant seemed to suggest, Company H was not resident outside Hong Kong, this matter was not applicable.

Dominant purpose

178. We must now look at the matters globally and arrive at an overall conclusion. We find that the dominant purpose of:

(a) the appellant, and

(b) the other participants in the Scheme,

was to enable the appellant to obtain a tax benefit.

Conclusion

179. The appeal fails on the section 61A point.

Disposition

180. With the exception of the assessment for the year of assessment 1993/94, all the assessments appealed against as confirmed by the Commissioner are confirmed.

181. In respect of the assessment for the year of assessment 1993/94, it is increased to show assessable profits of $84,829,978, with tax payable thereon of $14,845,246 (see paragraph 55 above).

Acknowledgment

182. We thank the team led by Mr Ambrose Ho for their able and helpful assistance in unravelling the convoluted Scheme. We thank the team led by Mr Barrie Barlow for making the exercise intellectually challenging.