Case No. D67/95

Profits tax – deductions of royalties – acquisition of patents.

Panel: Howard F G Hobson (chairman), Foo Tak Ching and Richard Lee.

Dates of hearing: 23, 24 and 25 January and 4 April 1995.
Date of decision: 2 October 1995.

The taxpayer was a wholly owned subsidiary of a company listed on the Hong Kong Stock Exchange. Claims for deductions of royalties by the taxpayer were disallowed. The Commissioner considered that certain of the transactions which royalties eventuated 'were commercially unrealistic and artificial'; that the sole or predominant purpose of the transactions was avoidance or mitigation of tax and that the royalties did not satisfy the deductibility requirements of section 16(1) of the Inland Revenue Ordinance.

Held:

(1) The royalties qualify for deduction from chargeable profits. Even if the seller were to have had obtained the benefit of section 16B(1)(b) before the sale, there is nothing in our tax law to make the deduction under section 16(1) of the royalties involved objectionable from a tax standpoint.

(2) Commercial benefit to the taxpayer by off-shoring the patents can be seen. The scheme and the transactions were not artificial under section 61.

(3) Taking an objective view of the 'transaction', it would not be concluded that the sole or dominant purpose was to enable the taxpayer to obtain a tax benefit.

Appeal allowed.

Cases referred to:

Wharf Properties Ltd v CIR [1994] 1 HKRC 90-073
CIR v Swire Pacific Co Ltd 1 HKTC 1145
D68/90, IRBRD, vol 5, 460
Seramco Ltd Superannuation Fund Trustees v ITC [1976] STC 100
CIR v Douglas Henry Howe HKTC 936
D44/92, IRBRD, vol 7, 324
FCT v Peabody 24 ATR 58 and 28 ATR 344

Ensign Tankers (Leasing) Ltd v Stokes [1992] STC 226
CIR v Lo & Lo [1984] 1 WLR 986
Fletcher & Others v FC of T 91 ATC 4950
CIR v Challenge Corporation Ltd [1986] STC 548
D52/86, IRBRD, vol 2, 314
D20/92, IRBRD, vol 7, 166

Luk Nai Man for the Commissioner of Inland Revenue.
Roderick Houng Lee of Messrs Price Waterhouse for the taxpayer.

Decision:

1. Introduction

This appeal concerns profit tax assessments as amended in accordance with the Commissioner's determination on 6 December 1993 for the four years of assessment 1988/89 to 1991/92 (the relevant period). The assessed profits concerned were:

- for the year of assessment 1988/89, additional assessment profits of $10,082,634 with tax payable thereon of $1,714,048;

- for the year of assessment 1989/90, profits of $119,373,037 with tax thereon of $19,696,551;

- for the year of assessment 1990/91, additional profits of $53,419,281 with tax thereon of $8,814,181; and

- for the year of assessment 1991/92, profits of $180,013,376 with tax thereof of $29,702,207.

In assessing the said profits the Taxpayer (Company T)'s claimed deductions of royalties were disallowed because the Commissioner considered that certain of the transactions from which the royalties eventuated 'were commercially unrealistic and artificial' (section 61 of the Inland Revenue Ordinance ('the IRO')), that the sole or predominant purpose of the transactions was avoidance or mitigation of tax (section 61A) and that the royalties did not satisfy the deductibility requirements of section 16(1).

The Taxpayer was represented before us by Mr Roderick Houng-Lee; the Commissioner's representative was the Revenue's chief assessor, Mr Luk Nai-Man.

2. Primary Facts

This covers matters mostly drawn from an agreed statement of facts, exhibits or unchallenged evidence. The dollar sign herein means Hong Kong dollars.

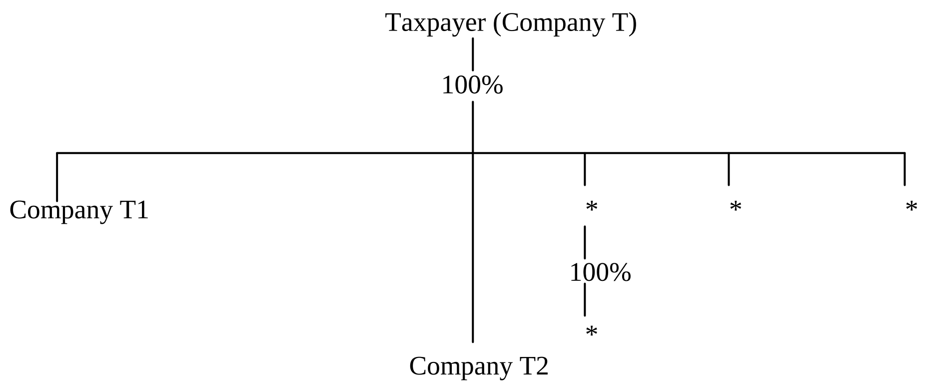
2.1 By the year 1948, Mr A was the proprietor of factories in Shanghai which manufactured textile products. Shortly after the Communist Party established itself as the de facto government of Mainland China, Mr A's factories came under the Party's control. In 1948 he managed to leave China for Hong Kong, leaving his wife and young children behind. In Hong Kong he set up a shop. In 1949 his wife and children managed to get out of China. In 1951 Mr A's factories in Shanghai were expropriated. In 1959 Mr A and his wife set up a factory in Hong Kong making electrical components. By 1960 their business had a turnover of $1 million and a staff of 30.

2.2 The Taxpayer, Company T, was incorporated in Hong Kong on 25 April 1960 and thereupon acquired the aforementioned electrical components manufacturing business, since when Company T's principal activity has been the manufacture of electrical components, used in various products.

Company T was listed on the Hong Kong Stock Exchange in 1984. However in late 1988 as a result of a court approved scheme of arrangement (the Scheme), Company T became a wholly owned subsidiary of Company X (holdings limited), a Bermuda corporation. This method of corporate reorganization of listed companies is known as 'redomiciliation'. The effect in this case is quite clear, the erstwhile listed company, Company T, was delisted and by an allotment of shares became a subsidiary of the new foreign company, Company X, which was listed in its stead.

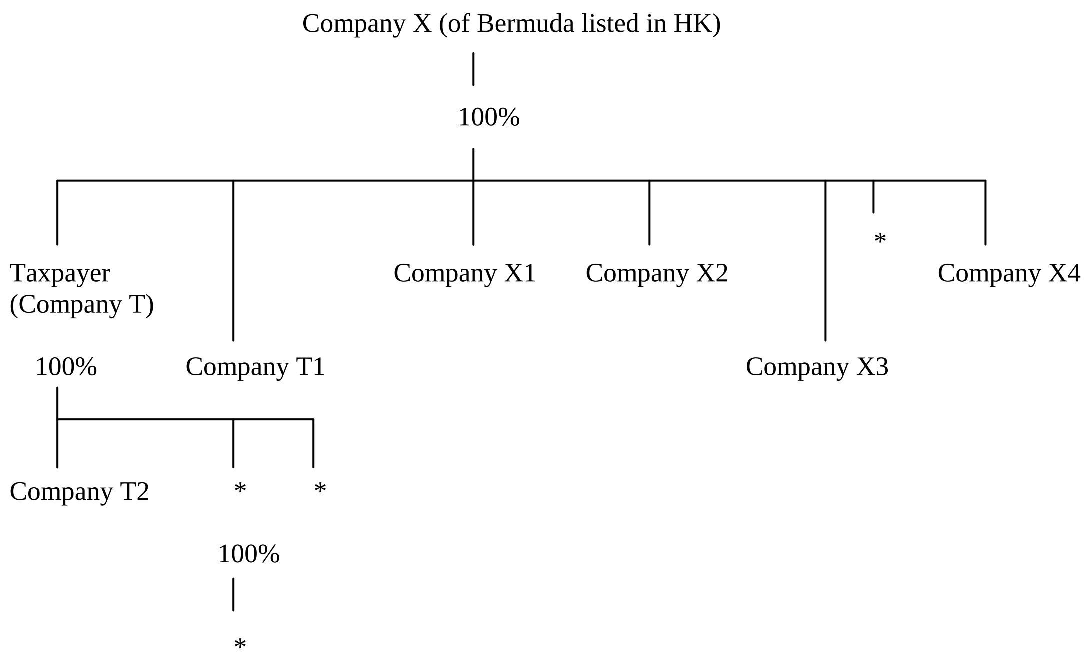
2.3 The following simplified extracts show the disposition of some X Group companies before and after the Scheme : others not shown are not material to this appeal.

BEFORE

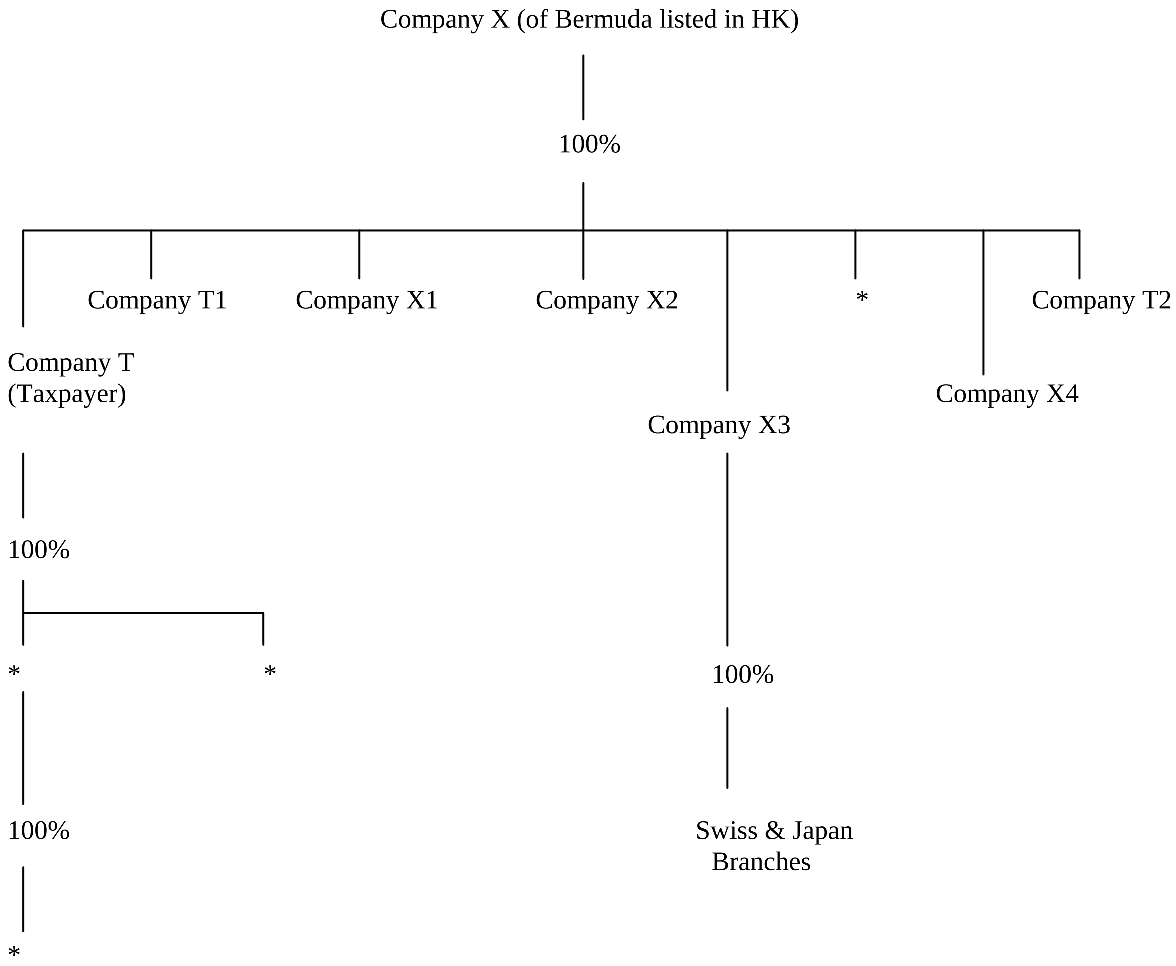


Note : * Hong Kong Companies not directly connected with this Appeal

AFTER



2.4 On 1 April 1990, Company T transferred its ownership of Company T2 of Switzerland to Company X. The X Group organisation chart after that transfer can be illustrated as follows:



After the relevant period the X Group set up a manufacturing company in Thailand as a subsidiary of Company X.

It is the Taxpayer's position, and we accept the same as a matter of fact, that as a result of the foregoing all of the assets of the Group which were not physically situated in Hong Kong or China became held by non-Hong Kong entities. The main non-Hong Kong asset-owning companies were Company T2, a Swiss company which as will be seen came to own the Group's patents, Company X1 a Bermudan company, which became a licensee of Company T2's patents, and Company T1 which is a US company. As it is Company T2's acquisition of patents which lies at the heart of this case, the nature of that category of intellectual property should be explained.

2.5 The following six abbreviated paragraphs are drawn from the January 1993 Report of the Patents Steering Committee (produced in evidence by Mr B who served on that committee) which, for the reasons expressed in paragraphs (5) & (6), was set up by the Attorney General in December 1986 to make recommendations to avoid a hiatus after July 1997.

'(1) *Technical innovation, … is the subject matter of patents. In order to encourage innovation the patent system makes an invention public in return for granting the inventor a monopoly right to exploit it for the term of the patent. … The patent itself protects the result of a business investment in research and development. The patent is an asset that can be licensed or assigned.*

(2) Because a patent protects the idea underlying the invention, the inventor can monopolize the various industrial forms in which the invention may be applied. … The monopoly that the patent gives is the right to manufacture, to sell, to use or import the invention and the right to prevent others from doing so…

(3) Hong Kong's patent law is currently dependent on United Kingdom patent law. Patent protection is obtained by registering in Hong Kong with the Registrar of Patents a United Kingdom patent or a European patent (UK). … The patent when registered in Hong Kong has effect in Hong Kong for so long as it remains in force in the United Kingdom. It is generally accepted that registration in Hong Kong gives the patentee the same right to sue for infringement as a patentee in the United Kingdom.

(4) The advantages of Hong Kong's present patent system are the patents registered in Hong Kong are strong, the system is inexpensive to administer and a businessman who already has a United Kingdom patent or European patent (UK) does not need to apply for a patent in Hong Kong which is subjected to fresh search and examination.

(5) China will resume sovereignty over Hong Kong in 1997. As it would be inappropriate for Hong Kong's patent law to continue to depend on United Kingdom patent law after 1997, Hong Kong should have its own legislation.

(6) The Sino-British Joint Declaration and the Basic Law of the Hong Kong Special Administrative Region adopted by the National People's Congress of the People's Republic of China provide for a separate legal system in the Hong Kong Special Administrative Region. Article 139 of the Basic Law requires the Government of the Hong Kong Special Administrative Region to protect by law achievements in scientific and technological research, patents, discoveries and inventions. Hong Kong will have to introduce its own patent system.'

Evidence was also given broadly to the same effect by Mr B, and by Mr C. We do not propose to revisit their evidence regarding the foregoing topic.

2.6 At all relevant times the A family has held a controlling interest in the X Group, Mr D, who is a son of Mr and Mrs A, is the managing director of Company T and Company X and a director of Company T2, Ms E, who is a daughter of Mr and Mrs A, is an executive director of Company X and Company T and Mr F, also a son of Mr A, is a director of Company X1 of Bermuda and a resident of the USA.

During the relevant period the X Group was a very large manufacturer with factories in Hong Kong and the People's Republic of China. By the end of 1991 the Group had a turnover well in excess of one thousand million Hong Kong dollars and a paid up capital of $30,800,000.

The X Group was at all material times (and still is) a very large and **independent** producer of electrical components in the world, one of its competitors, was (and is) the Y Group of Japan, also an independent producer : 'independent' is used to contrast the activities of large manufacturers, such as Z, which have their own subsidiaries producing electrical components. Amongst X Group's principal international industrial customers were (and are) 'a', 'b', 'c', 'd' and 'e'.

2.7 In May 1985 Y made threats of user infringement against X's customers in the USA, the UK and Germany regarding X's electrical components which Y claimed breached their patents. This immediately led to a series of suits, counter-suits, injunctions etc in the USA and Europe (the 'Y proceedings' – central to which was a prospective long term 'c' contract). Those proceedings were settled in 1987 at a cost to Company T of $16 million, of which $7.8 million were for legal fees. We have had the opportunity of examining some of the court pleadings, from which it is apparent that the proceedings raised complex issues and allegations.

2.8 In October 1982 following her visit to Beijing the British Prime Minister, Mrs Margaret Thatcher, reported to the Hong Kong public the results of her talks with officials. Her report was not well received and let to a decline in confidence resulting in a steep drop in the stock market and in the value of the Hong Kong dollar (subsequently pegged to the US dollar).

2.9 Prior to 1 January 1989 (the putative effective date of the transactions mentioned below), Company T incurred substantial research and development (R&D) expenses which were allowed in full for profits tax purposes pursuant to paragraph (b) of sub-section (1) of section 16B. The patents and designs resulting from the R&D were registered in Company T's own name. The R&D expenditure for the two preceding years were:

Year of Assessment	Capital Expenditure $	Revenue Expenditure $	Total $
1987/88	13,092,656	9,011,015	22,103,671
1988/89	9,071,031	13,348,240	22,419,271

3. The Transactions

The following five transactions were entered into and claimed to be effective from 1 January 1989 though in fact the agreements concerned were signed on 28 February 1989 – except for Transaction No 3 which was signed on 14 March 1989. The date of execution in each case was clearly set out in the testimonium pages. Copies of the five agreements concerned were produced to the Board.

Transaction No. 1 (Company T to Company T2 Intellectual Property Sale)

The Taxpayer (Company T) agreed, inter alia, to sell to Company T2 of Switzerland certain Intellectual Property developed by, beneficially owned by, and registered by Company T in its own name. The sales consideration was expressed to be $100 million.

The Intellectual Property that was sold consisted of 33 patents of electrical components registered in the USA, Taiwan, Germany, Hong Kong and the UK, 300 patent applications in Australia, Japan, Korea, the USA, the UK, the PRC, Germany, France, Italy and Taiwan, and two registered designs and two design applications in the UK. All of the foregoing were identified in a Schedule to the agreement.

Pro forma assignments for the patents were signed and filed over the following months in the patent offices concerned.

Promissory Note

The $100 million consideration was evidenced by a Promissory Note dated 2 January 1989 drawn by Company T2 in favour of Company T. This note was payable by four annual instalments of 15%, 20%, 30%, and 35% respectively, each due on 31 December beginning in 1989. The Note contained no provision for interest. This Note was displaced by the assignment of debt mentioned below.

Transaction No 2 (Licence Company T2 to Company X1)

Company T2 granted to Company X1 of Bermuda an exclusive worldwide licence, with the right for Company X1 to grant sub-licenses, over the following:

(i) the Intellectual Property (defined to include patents and applications) identified in the schedule to the Transaction No 1 agreement;

(ii) two electrical components patents registered by Company T2 in Switzerland; and

(iii) any **future Intellectual Property** in relation to the electrical components and/or their manufacture that might be acquired by Company T2 during the term of the Transaction No 2 agreement.

The consideration payable under the Transaction No 2 agreement was a sum equal to the aggregate amount of all **costs**, charges and expenses which Company T2 may incur or suffer in connection with or relating to the **creation**, discovery, **acquisition**, maintenance or renewal of the Intellectual Property or otherwise in relation thereto and on any **improvements** and/or the grant to Company X1 of the rights, licences and permissions referred to in the agreement. The amounts payable for item (i) above were not expressly mentioned but would in fact be the same as the four annual instalments totalling $100 million, referred to in the Promissory Note, because these instalments were acquisition costs incurred by Company T2.

The payment of the 'costs, charges and expenses' was stated to be 'in such manner, in such currency at such bank and at such time(s) as the parties may from time to time agree'. For item (i), as we said, they matched the original instalment amounts and the dates for payment mentioned in the Promissory Note.

During the relevant period, Company X1 incurred and paid further amounts (that is, in addition to the amortization of the $100 million) to Company T2 under the Transaction No 2 agreement, thus:

Year of Assessment	**$**
1988/89 (1-1-89 to 31-3-89)	3,866,245
1989/90	17,063,080
1990/91	18,631,080
1991/92	22,882,874
	62,443,279
	========

The above amounts represent the aggregate of monthly 5% royalty invoices raised in the name of Company T2. The actual invoicing was done in Hong Kong by

Company X's accounts department, which administered the inter-company current accounts, and which thereupon debited Company X1's account and credited Company T2's account. In consequence of the assignment of debt mentioned below Company X1 assumed responsibility for payment of the $100 million which was dealt with in the inter-company accounts by set-off entries for the annual amortization instalments.

As to the 'future Intellectual Property' a list of Company T2's new and/or improved patents or applications during the period January 1989 to September 1991 was produced to the Board. The total for those two years nine months was 51. Mr D put the total figure up to the date of his evidence at 190.

Transaction No 3 (Company X1 to Company T sub-licence)

The agreement first recited Company X1's licence from Company T2. It then went on to provide that Company X1 granted an exclusive sub-licence to Company T to use the 'process', to make or have made in Hong Kong, Macau, the PRC and Thailand (the territory) and to sell worldwide 'products' utilising the following Intellectual Property:

(i) in effect the same Intellectual Property referred to at (i) of Transaction No 2 (that is, the ex Company T Intellectual Property); and

(ii) any **future** Intellectual Property in relation to the electrical components and **any process of manufacture** of the electrical components which may have been or may be filed in or for use in the territory, to which Company X1 is or may become entitled to license.

Unlike Transaction No 2 the licensee's right to make the products was confined to the territory, hence Company X1, as the holder of a world-wide licence, could grant sub-licences to other companies for manufacturing outside the territory without infringing the exclusivity granted to Company T.

In consideration of the sub-licence, Company T agreed to pay Company X1 a royalty equal to 5% of its net sales (in effect, the amount Company T invoiced its customers).

During the relevant period, Company T incurred and paid (by the inter-company current account entries to which we have already referred) royalties under the Transaction No 3 agreement, and treated the same as deductible from its chargeable profits in its profits tax returns for the years concerned. The royalties incurred can be summarized as follows:

Year of Assessment	**$**
1988/89 (1-1-89 to 31-3-89)	10,082,634

1989/90	43,520,860
1990/91	53,419,281
1991/92	59,126,689
	166,149,464
	=========

As touched upon under Transaction No 2 in the four calendar years 1989 to 1992 there would be set against the royalties due to Company X1 the relevant annual amortization instalments of the $100 million as a result of the assignment of debt.

It is the Commissioner's disallowance of the said royalty amounts which has given rise to this appeal.

Transaction No 4 (Company T2 to Company X2 R&D Appointment)

Company X2 of Hong Kong agreed, inter alia, to perform for Company T2 such R&D services as Company T2 and Company X2 may from time to time agree. It was also agreed that the right to all technical information created, acquired or discovered by Company X2 in the course of its appointment under this agreement shall belong to and be the absolute property of Company T2, including the right to apply for and own any intellectual property rights relating to the technical information.

In consideration for the services to be provided by Company X2, Company T2 agreed to pay to Company X2 a fee equal to 110% of all costs, charges and expenses which Company X2 may incur or suffer in connection with or relating to the R&D services provided.

During the years relevant to this appeal, Company X2 derived the following fees under the Transaction No 4 agreement:

Year of Assessment	**$**
1988/89	1,866,033
1989/90	8,479,811
1990/91	8,992,681
1991/92	12,302,549
	31,641,074
	========

The above amounts represent 110% of Company X2's costs, accordingly 10% thereof represented its gross profits. Those profits have been assessed to Hong Kong profits tax in the hands of Company X2 for the respective years of assessment. (The Revenue has not suggested that Transaction No 4 offends Sections 61 or 61A.)

Transaction No. 5 (Administrative services by Company T2 for Company X1)

Company T2 agreed, inter alia, to provide such administrative services to Company X1 of Bermuda as Company T2 and Company X1 may from time to time agree. In consideration for the services to be provided Company X1 agreed to pay Company T2 a fee of SFr40,000 per annum.

Company X1 had (and has) no active staff. Bermuda lawyers provide nominee directors along with Mr F.

During the years concerned, the Hong Kong dollar equivalents of the said fee were:

Year of Assessment	**$**
1988/89 (1-1-89 to 31-3-89)	47,470
1989/90	195,902
1990/91	233,323
1991/92	211,825
	688,520
	======

Satisfaction of Promissory Note

An Assignment, dated 1 January 1989, among Company T2, Company T and Company X1 first recited that Company X1 owes Company T2 $100 million (that is, the acquisition cost for item (i) of Transaction No 2). It then recited that Company T2 owes Company T $100 million pursuant to Transaction No 1 agreement. Then Company T2 assigned the first recited $100 million debt to Company T, which assignment Company T accepted (without recourse to Company T2) as being in satisfaction of the secondly recited debt due to it by Company T2 and the Promissory Note evidencing it. As a result thenceforth Company X1 became liable to pay Company T in place of Company T2.

It will be recalled that the Promissory Note was dated 2 January 1989 this anomaly is dealt with in additional findings of fact paragraph 6.4.1.

Evidently the assigned $100 million indebtedness was replaced by an interest free loan to Company X1 by Company T of the same amount; as the Promissory Note did not provide for interest we see no need for the replacement. As no questions were raised we have treated it as inconsequential.

4. CIR's determination

In correspondence with the assessor and in its objections to the Commissioner Company T's tax representatives gave reasons for the foregoing transactions, of which our simplified version is as follows:

First the X Group's business focus was no longer primarily Hong Kong as it catered much more to markets in Europe, USA and Japan.

Secondly due to insufficiency of labour, expansion of production was taking place outside Hong Kong in China and Switzerland and was due to start in Thailand.

Thirdly concern for the continued integrity of the Group's intellectual property in the light of the uncertainty of applicable laws in Hong Kong after 1997.

Further reasons were exhibited to the determination, and more were also brought out in oral testimony before us.

On 6 December 1993, the Commissioner not being persuaded by the said reasons determined that the royalties incurred by the Taxpayer were not deductible for tax purposes on the following grounds:

(a) Transactions No 1 and No 3 cannot be described as ordinary commercial transactions, they were commercially unrealistic and 'artificial' for the purposes of section 61 of the IRO.

(b) Transactions Nos 1, 2 and 3 were entered into or carried out by Company T and the other parties to these transactions for the sole or dominant purpose of enabling them, either jointly or solely to obtain a tax benefit, as contemplated by section 61A.

(c) Transaction No 3 royalties were not incurred by Company T in the production of its chargeable profits and therefore failed to satisfy the deductibility requirement under section 16(1). Before us Mr Luk developed an argument, characterized as a 'double benefit', which is a refinement of this reason.

5. Witnesses

It is not necessary to recite the separate oral evidence of each of the seven witnesses, because in paragraph 6 below are set out the additional findings of fact we have drawn from their individual or collective testimony and an abundance of exhibits. Before doing so we propose to explain briefly who the witnesses were with a brief note of such of their testimony as is not included in the additional findings but which we think has some relevance or influence.

Messrs C, B and G appeared partly in the role of experts in their respective fields and partly as witnesses to certain events. In the former capacity their credentials were given at length but we shall not repeat them here, suffice it to say that their qualifications were never seriously challenged and they all appeared to us to be well qualified to give expert opinions. Moreover we received the impression that although each of them had undertaken work for the X Group, in giving their opinions they were careful to be impartial and were not drawn into exaggerating their opinions or the reasons they gave for them because of the business relationship. We have therefore accepted their opinions as being genuine, well formed and unshaken by lengthy cross examination. As to their evidence on factual matters we have accepted the same as reliable.

Messrs H, I and D and his sister Ms E are all directors of Group companies, they struck us as straight forward people and we have accepted their evidence as truthful.

Although we have mostly used the word 'patents' it should be taken to mean Intellectual Property Rights and applications therefor, unless the context suggests a narrower interpretation.

Our use of the expression 'management' is intended to mean Mr D, Ms E and others, such Mr I, who were be involved in making decisions on the topic in which the expression is used. Also 'expropriation' should be looked upon as including nationalization.

Mr C

Mr C is a partner of a New York law firm. His speciality is the law regarding intellectual property rights in which his experience and knowledge extend beyond the USA. He explained the law relating to patent registration and infringement actions as found in many countries. He was emphatic that the X Group and Y were two large producers in the market for the electrical components – worldwide. He gave his views regarding the importance of an extensive patent portfolio where a commercial duopoly exists an the need to constantly update original patented inventions by 'prosecuting' (meaning putting before patent offices the case for the granting of a patent) modifications, failure in either respect could result in an opponent achieving a monopoly position. He also gave his despondent opinion regarding the attitude of China to infringements perpetrated inside China against intellectual property rights held by foreigners. His evidence on this subject was coincidentally topical because at the time the USA was threatening sanctions against Chinese exports as a consequence of "Special 301 Hearings' in Washington into China's failure to enforce copyrights held by US companies in computer software, CD and audio tapes. He said that if the same sort of thing happened again after 1997 when Hong Kong was reabsorbed into China then such parts of the X Group as were active in Hong Kong could suffer whereas its non-Hong Kong activities and products probably would not.

He gave his reasons for considering that the 5% royalty charged by Company X1 to Company T was on the low side.

He was directly involved in the Y proceedings and explained them and their counter-suits at length and the culminating settlement agreement and the unsuccessful attempts to extend it when it expired.

Mr B

He is a qualified engineer and partner of the firm of Company J, chartered patent agents practising in Europe and Hong Kong. He drafted and prosecuted patent applications for professional clients such as solicitors and for lay clients including Company T and subsequently Company T2. He rendered assistance to Company T during the Y proceedings including the preparation of papers relating to actions against Y for revocation of patents which it held.

He gave us the views he held in 1986 (which are largely echoed in the January 1993 Report of the Steering Committee) on the seriousness of the problems which could arise after 1997, both for the holders of Hong Kong registered patents and for prospective applicants, due to the inability to register future inventions in Hong Kong if no new system were enacted to replace the existing system, which in his opinion will automatically cease to have any application because it depends for its international and local legitimacy upon an English statute, the extra-territoriality of which is assumed to become null and void on 1 July 1997. He went on to express concern should it be decided simply to maintain Hong Kong's re-registration system but substitute the PRC system (which was enacted in 1985) for the present UK/Europe initial registration. He held strong views on these subjects and, as mentioned, he joined the Patent Steering Committee when it was set up. In his opinion if the Steering Committee's 1993 recommendations are not implemented by 1997 then China will simply have a system of re-registration of Chinese registered patents or perhaps extend its own law to Hong Kong either of which alternative he felt could result in serious delays due to translation difficulties and problems arising from veto powers of the relevant authorities in relation to assignments. His interpretation of PRC's patent law is that any assignment – even between associated companies – must first be approved by the competent authority of the State Council; also no foreign registration by a PRC company is possible without prior approval from the said authority.

Mr B discussed his concerns with Mr I which led to a meeting in June 1987 with the Committee's Chairman, Mr K, so that Mr I could discuss those concerns. We accept that Mr K was unable to give any comfort.

Mr B had not been asked to value the patents to be transferred to Company T2. He had done valuations but only for liquidators but 'it is just incredibly difficult to put a valuation on any patent.' The following passage culled from a lecture he gave in 1991 rather neatly expresses one of the main imponderables:

> *'What benefit do you obtain from your patents? - First and foremost there is the deterent value. This cannot be quantified. You can never know how many times your competitors have been deterred from doing something because of patents you have.'*

He mentioned that although the statutory maximum life of a patent in most countries is 20 years, an analysis of a broad spectrum of technologies he did in the 1970s gave an average life of between seven and eight years.

He gave it as his view that it was the experience with the Y proceedings (which threatened to have a very damaging effect on the X Group's business) that galvanized the Group and caused them to concentrate far more than previously on applying for patents. He produced figures showing Hong Kong patent applications made in London or Europe (UK) after the Y proceedings from which he concluded that Company T was the single most prolific applicant; between 20-40 percent of all Hong Kong applications. In about 1988 the X Group took on two Company J men to handle its UK and European patent work.

As to royalties Mr B said that in the case of mechanical inventions the rate is normally between 3-7% and referred us to an English judgment and also a Patent Office decision where the range in each case was 5-7%: he said however that if the item concerned appears to be particularly profitable then it could be higher – pharmaceuticals exceed 40%, medical apparatus patent royalties range between 15-20%.

Mr G

This witness is a partner of a well-known Bermuda law firm, having a branch in Hong Kong which he set up in 1990.

His firm has been involved in the redomiciliation of existing Hong Kong listed companies or the incorporation and subsequent flotation in Hong Kong of new Bermuda companies. It is his understanding that about 45% of companies listed on the Hong Kong stock exchange are Bermuda incorporated ones of which his firm has dealt with about half.

He listed reasons why in his opinion Bermuda is a preferred jurisdiction of incorporation for Hong Kong listing purposes, of these we think the following worth repeating:

- The Bermuda redomiciliation precedent created in early 1984 by Company L and later by its related companies.

- Political, economic and social stability.

- A sound and well established legal system, with access to the Privy Council in the UK, and a banking and accounting infrastructure, which together offered security.

In his view the principal motivating factor for Hong Kong sourced parties to use Bermuda for Hong Kong listing purposes is 'asset protection' which he explained by saying that by placing the principal holding company outside Hong Kong in an acceptable jurisdiction certain protection may be afforded in international law from expropriation by the sovereign power in Hong Kong. Although that protection may not be effective with regard to Hong Kong based assets it should work for assets outside Hong Kong because they will have the benefit of the Bermuda umbrella. All of this is pertinent in the light of the apprehensions felt by many of those whose assets though located outside Hong Kong are owned by Hong Kong companies.

Dr H

This Swiss qualified physicist with a doctorate in electrical engineering was approached in 1987 by Mr D to establish Company T2's operations. By the time they met Mr D had already decided to base Company T2 in Switzerland a major centre in Europe for the manufacture of the electrical components, well served by universities, polytechnics and renowned consultants in the electrical component field. Dr H and Dr M were (and are) Swiss resident directors, Mr D made up the third member of Company T2's board.

Dr H gave evidence at great length and in depth, both in chief and in cross-examination, concerning Company T2's R&D operations, the number (from 2 at the outset to 13 in 1989 and 32 now) and quality of staff, its sophisticated work, its working relationship with Company X2 in Hong Kong, the branching out into process development as opposed to product R&D. He told us that Company T2's operations are housed in 2000 square metres of factory premises. He described Company T2 as the 'research institute' of the Group with more refined expertise and testing capabilities than either Company X2 or the Group's German company, Company X5 and the latter's subsidiary Company X6.

Though not involved in the decisions leading up to Transactions Nos 1, 2, 4 and 5 and the assignment of debt he was aware of them and approved of the intentions.

He expressed the opinion based on his observations before and after he joined Company T2 that Japanese manufacturers had over the past 15 years or so developed the technique of not merely patenting what he looked upon as 'true' inventions but also quite small variations thereby creating what Mr D had described to him as a 'minefield of patents'.

Dr H impressed us as being proud of the important part he considered that Company T2 plays in the Group's performance.

Mr I

He is a qualified electrical and mechanical engineer. He joined Company T in 1978 and became a director in 1980. In 1990 he went to the USA where he became (and continues to be) a director of Company T1, which is responsible for marketing X products in USA.

He was directly involved in the conduct for Company T of the Y proceedings. Patent searches were made in many jurisdictions which revealed that Y had a large patent portfolio much of which related to small innovative steps, even so the latter created substantial barriers for competitors. This changed his attitude consequently 'Company T began to have patents drafted for every useful idea which emerged. X's patent portfolio rapidly grew as the company encouraged innovation from all of its staff'.

He gave as one reason behind the establishment of Company T2 the large turnover of Company T's R&D staff which he attributed to the unnerving political climate in Hong Kong at that time. He urged his co-directors to consider establish an engineering company in a stable country where experienced engineers could be expected to remain with the company for prolonged periods.

Mr I explained at length his own worries about both the uncertainly of the patent system to be used in Hong Kong after 1997 and his belief, based on anecdote, that patent enforcement in China presented serious problems. He was 'concerned that even if before 1997 Hong Kong's legislative draftsmen arrived at a suitable format [for a new system to replace the present one], there was no certainty that China would feel obliged to respect the Hong Kong law after 1997.' Mr I told us that his meeting with Mr K in June 1987 did nothing to quieten his anxieties.

Based on an intercession in China by the US government for Union Carbide concerning infringement of a trade mark it occurred to him that if Company T placed its intellectual property within a foreign country then China would have more respect for it. On 5 January 1988, after urging co-directors to agree to a transfer offshore, he wrote a memo to Mr D which was produced to the Board and ends with a recommendation that 'we … consider a way in which the patent owner can be foreign to Hong Kong.' We accept that the memo was authentic. Mr I believed that the PRC patent office was keen to promote registration, for which fees are relatively high: that office however, in his view, has shown less interest in the handling of infringement disputes though the administrative authority for patent affairs does have jurisdiction. In this context we should mention that Company N provided a letter of 12 May 1993 which stated that in 1988 … 'it was still not known to what extent a [PRC registered] patent could be effectively enforced after it was granted.' It may be that the subsequent 1992 revisions of China's patent law have resolved this uncertainty – we are however in no position to judge.

Mr I reiterated the contemporaneous opinions he expressed to M D about the difficulty of putting a value on the patents to be transferred to Company T2 and hence he was unable to help Mr D. However he felt that a 5% royalty was a fair average for mechanical inventions though probably less than Company T would have to pay a third party.

He said that at none of the various meetings which he attended concerning patents transfer was the subject of Hong Kong taxation raised.

Ms E

She holds a BSc degree and is an executive director of Company T and Company X and is responsible for the financial planning, purchasing and legal affairs of the X Group.

Her evidence regarding the Group's history and the Y proceedings is similar to that of her brother and Mr I. She told us that her father's experience at the hands of the Communists coupled with L's redomicilation move and concerns for the status of Hong Kong patents after 1997 all played a part in deciding to redomicile and transfer the existing patents to Company T2 and thenceforth using Company T2 as the Group's holder of patents. She also said that the Group had become so international that centralized management and control was no longer an efficient way to operate. Divisionalisation would also facilitate the implementation of more effective management accounting and performance appraisal systems, and therefore provide better motivation for heads of divisions.

She estimated that the 1995 Hong Kong dollar equivalent of the total cost of the Y proceedings and settlement was about $32 million.

At a meeting on 11 February 1988 (that is, about six months after Company T2 was established) Ms E sought advice from Mr O of Company J (with Mr B in attendance) on how best to protect the patents. Though Netherlands Antilles, UK, USA and Netherlands were mooted, the consultants' recommendation was to use Company T2.

Ms E explained the need to interpose a licensee between Company T2 and Company T, namely if Company T2 derived profits from the exploitation of intellectual property rights and then distributed those profits to its shareholder the Swiss authorities would subject the dividends to 35% withholding tax, if however an exploitation licence were given to a tax haven company (Company X1) in consideration of the reimbursement of Company T2's costs, Company T2 would have no profits – hence no dividends. She mentioned that one incentive for setting up Company T2 was the 10 year holiday from profits taxes normally imposed by the Swiss federal and local authorities however that holiday did not apply to withholding taxes.

Company T transferred its previous R&D team (of about 40) to Company X2 effective 1 January 1989 thereby separating R&D from manufacturing and sales in line with the plans for divisionalisation and providing Company X2 with staff to carry out work in Hong Kong for Company T2.

As regards the various intercompany accounts she said that during the period 1 January 1989 to 31 March 1992:

(a) Company T2 paid Company X2 about $32 million [actually $31,641,074] pursuant to the service agreement (Transaction No 4) the profits on which were taxed in the hands of Company X2.

(b) Company X1 paid Company T2 $162 million pursuant to the reimbursement arrangement in Transaction No 2 made up as to:

(i) the $100 million Company T2 incurred to Company T for the assignment of the subsisting patents;

(ii) the $32 million referred to at (a);

(iii) a total of $30 million in further expenses incurred by Company T2 in connection with the creation, discovery etc of new or improved intellectual property (that is, those referred to in the Transaction No 2 agreement as 'future Intellectual Property'.)

The above were dealt with in the intercompany accounts and thereby treated as paid, in the case of (i) by annual instalments over four years, and in the case of (ii) monthly. Copies of the monthly invoices and vouchers were produced to us.

(c) Company X1 paid Company T2 $688,520 for Company T2's administration services, set at SFr40,000 per annum (apportioned for the period 1 January 89 –31 March 89) under Transaction No 5.

Finally regarding the amounts she advised that during the said period Company X1 derived slightly over $166.1 million from the sub-licence granted to Company T. This is the total of the disallowed royalties, the break-down of which is shown at the conclusion of the description of Transaction No 3.

She further explained that the transfer on 1 April 1990 of Company T2 from Company T to a subsidiary of Company X was to ensure that Company T2, an offshore company, would not be owned 'via a corporate ownership chain which included Hong Kong'.

Ms E referred to the management's belief that a foreign patentee would stand a better chance of enforcing intellectual property rights in China. She illustrated this by reference to a case (the P case) the Group officially instituted in China early in 1994 against several manufacturers and suppliers there who were infringing their patents. This led to the Group receiving an approach from representatives of the trading arm of a local government which was close to and had an interest in the infringing factories who pressed X to 'find ways to avoid this action'. When it was explained that the patentee was Company T2, a Swiss corporation, and not Company T (which the trading arm knew to be a Hong Kong company they agreed that the P action could proceed, provided the trading arm was not included as a defendant.

Ms E mentioned that as early as 1983 the Group had investigation setting up production facilities in Thailand as a 'worst case scenario' and though support was received from the Board of Investment in Thailand the proposal was left in abeyance. However it was reactivated in 1988 partly because of 1997 concerns and also to cope with expansion of the Group's overseas markets, A factory has since been built and production began in May 1992 and presently accounts for 10% of the Group's output, making the point that it is capable of very much larger expansion. We infer from that remark that if a worst case were to materialize and the use of the China and Hong Kong factories were lost or severely circumscribed then the damage could be mitigated through the enlargement of the Thailand facilities.

During cross-examination Ms E was referred to the calculation which her accounts people had prepared after Mr D had decided the consideration for the patents transfer should be $100 million. The calculation compares four annual instalments payable under the Promissory Note (15, 20, 30 and 35 million dollars respectively) with the 5% royalty payments based upon an estimated $800 million turnover for Company T for each of 1989 and the three ensuing years (40 million dollars per year) which results in a total of $160 million (800m x 5% x 4). Mr Luk in effect said the $100 million capital receipt compared very unfavourably with the $160 million outgoing – 'So on that basis Company T needs to pay $60 million to Company X1, at the same time getting rid of its most valuable property.' Ms E's response was to the effect that as already indicated under Transaction 2 Company T2's R&D expenses over the same four years came to $62.4 million which should be looked upon as a saving for Company T because it would no longer have to bear them. Ms E had already pointed out that the $100 million was the consideration for the transfer of **existing** patents, whereas in return for the 5% royalty Company T got the benefit not only of the transferred patents (some of which would shortly expire) but also all **future** new patents and applications arising from Company T2's R&D work. As mentioned we saw a list showing 51 new applications and patents over the first two years nine months of the said four years and we accept Mr E's evidence that the number had reached 190 by early 1995.

Ms E dealt capably with some complicated questions in cross-examination.

Mr D

Mr D, with an MSc degree in electrical engineering, is the managing director of Company X and a director of Company T, Company T2 and other Group companies. He is normally resident in Hong Kong.

He explained the history and growth of the X Group and the global expansion of sales beyond Hong Kong and China in the 1980s. The Group sells over 200 million electrical components a year. He gave an example to show the extent to which the Group's components are used in a product – the potential is for 19 components per product. Amongst other facts he mentioned that the Group supplied thirty million components for the 'a' company. He produced some sample components and explained how they worked. One of the samples had four patents. He took us through photographs of Company T2's factory and laboratories, machine tools and automated machinery.

He gave his reasons for believing that innovation and use of the latest technology were important in the electrical component manufacturing business and the creation and ownership of related intellectual property rights. Central to his reasons lies the salutary lessons learned in consequence of the trauma of the Y proceedings.

He also explained at length the reasons for the decision to set up a research and development function outside Hong Kong – basically the need for more advanced R&D work the know how for which was not available in Hong Kong and, in Switzerland in particular, the ready availability of quality craftsmen, engineers, and renowned specialists and consultants, all experienced in the electrical components, unavailable in Hong Kong. He told us how Company T2 solved a product problem for the 'a' company.

His reasons for the transfer of the Company T patents were explained. There went many but can be compressed into the importance of its parents to the Group and the fear for the status of those patents and innovations after 1997 and the effect upon the confidence of customers in the face of not only the uncertainty of Hong Kong's future patent law but also their misgivings about the impartiality of the Hong Kong courts should the customers need to sue X companies after 1997. Those customers for whom the group represented virtually the only source of supply expressed concern as to the Group's ability to continue to supply innovative products after 1997. These factors plus the precedent of Company L and his father's experiences at the hands of the Communists in Shanghai also lay behind the redomiciliation decision. The transfer of the patents was forecast in his father's letter to shareholders of 2 November 1988 mentioned below.

His evidence also dealt with attributing a value to Company T's patents. Though he was unable to get any clear guidelines from others, such as Mr I or accountants, the figure of $100 million seemed to him to be reasonable. The Group's accounts department produced the calculation referred to in Ms E's testimony which he and they felt supported his $100 million figure.

As to the 5% royalty he was influenced by the range of percentages which cropped up during the Y Proceedings and views expressed by Mr I.

The following is extracted from the letter of 2 November 1988 by Mr A as Company T's chairman appearing in the Scheme circular:

> *'The activities of the Group have developed to a point at which your directors consider it appropriate to create a structure in which the Group's activities are fully divisionalised so as to make more efficient use of the Group's overall resources. Accordingly, to rationalise its activities, it is intended to separate research and development from manufacturing, manufacturing from the Group's marketing activities and, additionally, to reorganise both*

> *manufacturing and marketing by reference to geographical location and area of operation.*
>
> *To add to our Hong Kong resources a wholly-owned subsidiary has been established in Switzerland which concentrates on research and development and provides technical support for developments created within other Group companies. Group developments which are capable of protection by patent are increasing, and to facilitate protection of the Group's intellectual property rights worldwide, this subsidiary will hold the Group's patents. As part of the reorganisation a new research and development subsidiary has been incorporated in Hong Kong which, initially, will be staffed by those present Group employees who have been concentrating in this area of the Group's activities and this company will co-operate and exchange information with the Swiss research and development subsidiary.'*

Understandably Mr D's evidence was long and his cross-examination was (quite properly) comprehensive, nonetheless we did not feel that the favourable impression we experienced during his examination in chief in any way suffered in consequence.

Affidavit Evidence

There was produced before us an affidavit of Mr Q who was a partner of Company N and a non-executive director of Company T. He recalled attending directors meetings in the autumn of 1987 concerning the proposed redomiciliation and the transfer of the patents and remembers that at none of those meetings was there any suggestion that these proposals would lead to tax benefits for the Group – that subject was never referred to. During these meetings Mr Q took the role of 'Devil's Advocate' by questioning the necessity of the reorganisation and patent transfers having regard to the expense and time involved. His affidavit continues:

> *'Nevertheless, I knew, and was obliged to recognise that, at that time, the concern expressed by Mr A and Mrs A was not unique to them, and not only in Hong Kong. I was also obliged to recognise that the expropriation of the patents at, or at any time subsequent to, mid-night on 30 June 1977 would, according to my understanding of Private International Law, as the act of the then Sovereign State, be recognised by overseas courts as valid, and that the loss of the right to exploit its own patents would be extremely damaging to the Group's on-going manufacturing capability. That was for two reasons. First, the patents give and will continue to give the X Group a considerable commercial advantage over other manufacturers of the electrical components whereby any expropriation of the patents and their subsequent use by licensee(s) or transferee(s) of the expropriating authority would transfer that commercial advantage to such licensee(s) or transferee(s). Secondly, the effect would be that the X Group's overseas manufacturing plants would be unable to continue to exploit the patents without incurring the risk of being sued for infringement of the rights of the new owner as well as those to whom the*

expropriated patents had been licensed or transferred. Accordingly having been satisfied that securing for the x Group the continued ownership of, inter alia, the patents and the exclusive right to determine how they should be exploited constituted on extremely sound commercial reason for the reconstruction, I supported the proposal without further hesitation.'

6. Additional Findings of Fact

6.1 Y Proceedings

The consequence of these proceedings was to focus the attention of the Group's policy makers upon the great importance, in the circumstances of the existing commercial duopoly, of a comprehensive patent portfolio, a minefield which, beginning about 1985, led to an upsurge in patent applications by Company T to a figure representing about 20-30% of all Hong Kong applications, which were initiated internally by Mr I and handled externally by Mr B's firm.

The Y proceedings had impelled the X Group to take a much more vigorous approach to the protection of their inventions, modifications and improvements so as to create a minefield of patents.

The Group's legal and professional fees showed an increase in 1986/87 over the previous year of over 300% for fees 'in connection with the registration of patents, trade marks and logo'; the increase, though smaller, continued until 1989/90 when it dropped away to a figure which was relatively trivial and which we accept was not related to any patent applications by Company T. We accept this information as support for the statements of Messrs D, I and B about the intensity of its patent application work as a result of the Y proceedings.

6.2 HK Patent System

During the relevant period IPR practitioner, inventors and the Attorney General's chambers were all acutely aware of the serious and real problems which had to be resolved quickly due to the uncertainty regarding Hong Kong's post 1997 patent system. It was quite clear that the lack of resolution would undermine the confidence of the customers in the validity of the X Group's patents after 1997. This led to investigations, through lawyers and IPR practitioners in many countries, as to how such assets might best be protected. The conclusion was that the transfer of Company T's existing patents to Company T2 and thenceforth using Company T2 as the applicant for future inventions or modifications was a sensible solution. The transfer was presaged in the scheme of arrangement and was therefore an important adjunct to the redomiciliation, though understandably no mention was made of the underlying political concerns.

Mr I memorandum to Mr D of 5 January 1988 urging an early decisions on placing the patents offshore was the culmination of informal recommendations he had made, and was written because his repeated recommendations were still not then being translated into action and the longer the procrastination the greater his anxiety. Moreover the more patents Company T registered in the interval the greater would be the transfer fees involved. In the circumstances we do not agree, as was suggested by Mr Luk, that the 1989 transfers were premature.

6.3 1988 Redomiciliation

We accept that this was prompted by a combination of the following:

(a) The atmosphere of pessimism, born of scepticism, amongst many in Hong Kong following Mrs Thatcher's visit to Beijing and report to Hong Kong people in December of 1982 which was not allayed by the fitful and tense 'useful and constructive' Sino-British negotiations over the next two years. That a mood of scepticism for Hong Kong's political future existed is quite clear from Company L's announcement in early 1984 to redomicile to Bermuda: that company too had its China assets expropriated in the 1950s. The L Group, comprising several large listed companies, with a long local history was a leading institution, it is not surprising therefore that this announcement, and the actual redomiciliaiton in May of 1984, struck a chord amongst some other listed companies, including particularly the X Group because of the expropriation Mr A had suffered. The signing of the Joint Declaration was followed by a new difficult chapter of discussions concerning China's proposed enactment of the Basic Law for Hong Kong. The large number of listed companies that have redomiciled since supports the view that the A family were influenced (and not uniquely so) by L's momentous step taken despite the assurances contained in the Joint Declaration.

We therefore accept as true that the Taxpayer's directors were indeed influenced substantially by their fears for the future. We do not accept Mr Luk's suggestion that the A family exaggerated and were not influenced by the 'China factor' or the '1997 factor'. We can see however that it would not have been tactful to air such pessimism in the 1988 Scheme circular while at the same time operating factories in Mainland China; the omission is understandable and does nothing to undermine our foregoing finding.

(b) From about the mid 1980s Company T was finding it hard to keep its qualified staff and we accept that the management believed that his was because they wanted to work for foreign owned companies as a result of the pessimism referred to above. The disenchantment is shown by Mr I recruitment of twelve university students all of whom had left within three months, three of whom told him they wanted to work for a foreign national company. Granted neither Company T, which was in future to concentrate on manufacturing, nor

Company X2, which was to take over company T's R&D staff, were foreign companies but the redomiciliation would mean that thereafter they would be owned by a foreign company.

(c) By 1988 the international nature of the Group's customers (and the latter's misgivings about future dealings with a Hong Kong company), led to decentralisation in the way envisaged in Mr A's letter. This resulted in an R&D division (with its own separate brief aimed at building a large patent portfolio), following on from the establishment in August 1987 of Company T2. The Group now has research and development companies in three countries, Company T2 in Switzerland, Company X2 in Hong Kong and, since 1992, Company X5 and since 1993 Company X6 (which has entered into joint collaboration agreement with a German third party) in Germany each complementary to and working closely with the other. We consider this evidence and the separate marking companies and the Thai factory all of which have been established since the redomiciliation support the view that the divisionalisation reason was a genuine one.

(d) The Taxpayer's directors had become aware of the importance of its patent portfolio and believed that its subsequent transfer to Company T2 would not only afford protection from expropriation but also avoid the post July 1997 patent registration conundrum referred to at 6.2 above. Experiences since the portfolio transfer, such as the P action referred to by Ms E, the anecdotal tales referred to by Mr I and Mr D, the threatened Special 301 Sanctions threatened by the USA, and the continued absence of appropriate legislation despite the Steering Committee's 1993 recommendations all go to show that the doubts and anxieties of the witnesses regarding the integrity of China's patent law and the potential hiatus for the Hong Kong system were not invented for the purpose of the Hong Kong tax proceedings.

(e) Expropriation of Company T's patents would mean that the Group's factories, including the Thai one could not function (at least as the management would wish) without a licence from the expropriating power.

6.4 Patent Transfers

6.4.1 Although all of the agreements for Transactions Nos 1 to 5 inclusive were signed well after their effective date of 1 January 1989 a review of the Commissioner's determination and of the questions put in cross-examination do not suggest that anything suspect can be read into the retroactivity. Indeed the documents were drafted to show the actual signing dates, which is quite at odds with any subterfuge. Ms E believed it took time (from about 1 January to the singing date 28 February 1989) to garner in and check details of the patents and we can see from sample papers that that could well be the case and accept her explanation. The respective pro forma assignments actually used for registration were in many languages, required notarizations and legalisations and other formalities. We also accept that the reason that it took many months (in some cases, years) to process the pro forma assignments was the considerable number of patents, patent processing agents, and patent office formalities involved: no adverse inferences can be drawn from those delays. We therefore find 1 January 1989 should be treated as the effective date.

There is an anomaly with the Promissory Note, it was dated **2 January 1989** yet the assignment of debt whereby the Note was satisfied was dated **1 January 1989.** Ms E said 2 January date was a mistake. We agree that that must have been the case, we can think of no other plausible reason.

6.4.2 Transaction No 1 agreement contains a definition of the assigned Patent Applications which refers to 'all subsiding or **future** applications for patents'. Much was made of this by Mr Luk since it appeared to imply that Company T would continue to involve itself in R&D work after 1 January 1989. We accept that Company T ceased to do such work after that date and believe that 'future' was included needlessly by the legal draftsman, though it is the sort of precautionary draftsmanship one might find in an arm's length document to ensure that if the seller, contrary to a promise not to compete, were to register patents they would nonetheless belong beneficially to the buyer.

6.4.3 As of 1 January 1989 Company T not only became the sub-licnesee of the then subsisting Intellectual Property set out in the schedule to the Transaction No 1 agreement, but also became entitled through Company X1 to manufacture the electrical components the subject of all Company T2's **future patents** and **applications** for patents as well as two which Company T2 itself held before that date.

6.4.4 To show as was done only nominal considerations in the formal individual assignments by Company T of the patents is a customary and acceptable practice.

6.4.5 Company X2 took over Company T's research staff of about 40, effective 1 January 1989.

6.5 Company T2

6.5.1 The following commercial reasons played a significant part in the decision to establish an R&D centre in Switzerland:

(a) Proximity to Continental Europe's market and learning and research institutions.

(b) Certain area in Switzerland has an electrical noise free environment conductive to experiments in electrical noise and noise suppression and studies with cordless machinery.

(c) The ready availability of precision mechanics etc.

(d) The welcoming reception extended by the Swiss authorities, including the 10 year tax holiday incentive, salary subsidies for local employees and a SFr2.85 million loan from a local bank the interest on which was partly subsidised, all of which incentives were adequately documented before the Board.

Company T2 was not incorporated in August 1987 specifically to act as a repository of Company T's patents, that idea emerged after Ms E's meeting with Mr O in February 1988 and seems to us to have been the logical choice.

6.5.2 The reason why Company T2 was not transferred to Company X effective 1 January 1989 was that it was believed, as explained by Ms E, that no change of shareholding should take place until all the concessions and incentives by the Swiss authorities were in place.

6.5.3 Company T2 was from the outset in August 1987, and continues to be, an active semi autonomous organization of real substance whose original raison d' ȇtre was to provide a degree of sophisticated technology, testing and inventive exploration which could not be achieved in Hong Kong, partly because of the lack of dedicated technicians due to the 1997 syndrome or lack of technicians with the requisitive experience and the absence of consultants of the stature of those in Switzerland and partly due to the inability to carry out dangerous testings because Hong Kong does not permit them because the facilities to cope with them do not exist in Hong Kong.

6.5.4 Company T2's role became that of the Group's research institute, that is, the centre for esoteric and adventurous generic research both for **products** and **processes**, as witness work on certain electrical components, novel parts, 3D technology, branching out into automation designs, and sophisticated testing of inventions. (Company X2's testing, like the more recent Company X5, tended to be more specific and customer oriented). By 1 January 1989 Company T2 had designed and applied for patents for two different electrical components and subsequently Company T2 developed a dozen more such components. Company T2's refined workmanship enabled the production by automation of components with a validation rate of twenty defects per million parts.

Company T2's **process** R&D led to the purchase of a machine which after adaptation by Company T2 became the forerunner of more than three dozen machines used by X Group factories in China, Hong Kong and Thailand. In addition to pure **product** and **process** R&D Company T2 manufactures components which it supplied to group factories where they are assembled into finished articles and sold to customers. Company T2 did not sell its products or designs to outsiders that is, non-Group companies.

6.5.5 The relationship of Company T2 and Company X2 at its most simple was (and is) that Company T2 proposes in innovation, machines the prototype, tests it itself then engages Company X2 to test its prospective practical application for use in the appliances of Group customers. There is much exchange, by visits and telephonic communication, of views and refinements before the innovation is perfected to a feasible level, including developing it to meet a predetermined life span, or is abandoned for lack of interest or cost.

One of the Group's German subsidiaries plays a role similar to Company X2 in relation to German customers, such as 'f', 'g' and 'e'.

6.5.6 After 1 January 1989 Company T2 alone became the applicant for all of the Group's patents and improvements. However the applications themselves have first to be approved by Mr D (also a director of Company T2) before actually being passed to patent agents for processing. As Dr H put it, since Company T2 is not involved in selling products its Swiss directors are not best placed to judge the usefulness of the innovations concerned. During the relevant four year period the number of new applications and patents processed by Company T2 was much greater than the 51 shown in the list for the first two years and nine months.

6.5.7 Company T2's activities have contributed greatly to the success of the Group's electrical components, by, amongst other things, reducing product failures to a rate attractive to the Group's customers, and reduction of production costs.

Some cross-examination of Dr H appeared to cast doubt on whether Company T2 did conduct R&D work . The above findings answer that doubt.

6.6 Company X1

Having decided to protect the patents against expropriation by the transfer to Company T2 and bearing in mind that if Company T2 were to grant a world-wide licence direct to Company T in return for royalties then any consequential dividends paid by Company T2 would attract 35% Swiss withholding tax a direct link was decidedly an unattractive one. It was put to Ms E in cross-examination that Company T could have assigned the existing patents to Company T2 for a nominal one dollar which in turn could have licensed them back at a nominal figure and could have segregated them from future patents developed by Company T2. Ms E said those possibilities had never occurred to her. For our part, we think such a scheme would on the face of it appear to be artificial for want of consideration and even though it may not give rise to tax consequences it might have left the transfers open to challenge (for example, in infringement actions or if Company T were expropriated) on the grounds that as no consideration was given Company T2 was a constructive trustee for Company T. Ms E thought that for Company T to charge Company T2 a consideration for the patent transfers even though the companies were related was in accordance with good accounting practice; she said that was also the reason for charging Company T a royalty. This assertion was not challenged, accordingly, we accept that in principle Ms E is correct.

Moreover it seems to us that it would not have been sensible to leave the existing patents with Company T (another suggestion by Mr Luk) and letting Company T2 assume responsibility for improvements to those base patents (as well as new inventions) because if the base patents were expropriated Company T2 would be prevented form keeping the improvements.

Accordingly we accept that following upon professional advice Company X1 was incorporated in the tax haven of Bermuda for the express purpose of enabling Company T2 to make no profit thereby avoiding any question of Swiss withholding tax and find that that arrangement made commercial sense for the Group as a whole. As we heard no suggestion to the contrary we take this tax avoidance ploy not to be inconsistent with Swiss tax laws.

6.7 Infringement actions in PRC

It is open to a patentee to take action not only against an infringing manufacturer but also against those to whom he supplies the offending article if the patent applies in the recipient's country. However we accept that to seek redress against the recipient could be commercially rash if he is also a major customer of the patentee and is an unwitting party to the infringement. We can see that a patentee would prefer to proceed against the manufacturer. We can also see that X's management had by 1988 heard enough to believe that if the manufacturer were located in China then action by a Hong Kong patentee (even before 1997, as well as after) is likely to be less successful than action by a foreign patentee. Moreover on the evidence we heard we consider that such cynicism was genuine and not borne of paranoia: it is irrelevant whether or not we would have shared that cynicism. We consider this cynicism was an additional reason for the transfer to Company T2, (see 6.3d above).

6.8 Patent Valuation

6.8.1 There is no incontrovertible method of valuing intellectual property. One can readily appreciate that possible criteria include the remaining useful life of the patent, the availability of other patented or unpatented alternatives, the potential profitability, whether the pool of potential customers is wide or narrow etc. and the possibility that it may be challenged on 'prior art' grounds. Nor was there any evidence of arm's length sales available to X's management or consultants to serve as a comparison.

When cross-examined concerning the reason for not attempting to establish how many articles the Group sold were attributable to any given patent Ms E said:

'… it is difficult to segregate patent by patent because one patent may be used by different models and sometimes one component may incorporate different patents in the same component.'

We consider this and the number of patents and applications concerned satisfactorily answers the question.

Although Mr B mentioned an analysis he did in the 1970s of a broad spectrum of patents – including pharmaceutical where the tendency is to keep them registered for the maximum registration period (usually 20 years) – and came up with an average life of seven to eight years he said that was purely a statistical finding, X however would have to form its own view. We have referred to the cross-examination of Ms E concerning a calculation done by Ms E's department and we accept that the assumed **average** commercially feasible life of four years for the Company T patents and applications was not an unreasonable one and consider that the calculation afforded acceptable justification for that figure. We therefore accept that the $100 million consideration settled upon by Mr D was as reasonable a figure as could be expected in the circumstances and find as a fact that it was a genuine figure.

6.8.2 We accept that, contrary to Mr Luk's implications, patent **applications** themselves are valuable to the applicant because if they are successful the first in time will prevail and also when the applications are published they may tend to put off the applicant's rivals or perhaps cause them to show their hand by challenging the application. There is another less obvious advantage namely if though the invention is sound it is felt before the publication date to be ahead of its time then the applicant can withdraw the application thereby preserving secrecy until he decides the time is ripe for exploitation when he can apply once more. We mention this point only because it arose in cross-examination.

6.9 Royalty Rate

6.9.1 We note that 5% is the royalty figure laid down in the arm's length joint collaboration agreement entered into in July 1993 between Company X6 and a third party in Germany.

6.9.2 We accept that the expert opinions of Messrs C and B and the subjective views of Messrs I and D, formed largely as a result of negotiations centred on the Y proceedings, were all genuine.

Amongst the Taxpayer's exhibits were three UK cases concerning non-exclusive licence of right applications under section 46(3) of the Patents Act 1977. In case 0/150/94 concerning a guard rail the royalty was set at 10% of the licensee's net sales value. In 01/155/94 regarding a fishing rod bite indicator the royalty would have been set at 6% but for the number of other licences that existed, so it was fixed at 4%. In Cabot Safety Corp's Patent the Court confirmed the hearing officer's decision of a fixed amount for each earplug sold, which equated to about 21%.

If Company T2 comes up with a truly momentous invention 5% will seem cheap. We therefore find that 5% was a reasonable and not an excessive figure.

6.10 Miscellaneous Findings

6.10.1 The administration services for which Company T2 charged Company X1 an annual fee under Transaction No 5 appear to us to be more in the nature of an additional licence fee because it was (at least in part) a charge for Company T2 arranging custody of its own patents – the charge being justified on the grounds that as licensee Company X1 benefitted from the safe custody.

6.10.2 That no security was given by Company T2 to Company T for the $100 million comes as no surprise since both were wholly owned by Company X and as Company T2 did not trade with outsiders it was not taking any commercial risks. Company T2's inability to pay would be due to Company X1 receiving royalties from Company T which fell short of the required instalment. In theory, as Mr Luk pointed out, that was a possibility but in practice it never happened. However Ms E said that the instalments of debt were designed to be smaller in the earlier years to accommodate that remote possibility. In the circumstances of this case the lack of security is entirely a neutral factor.

6.10.3 The Transaction No 2 agreement requires Company T to supply Company X1 with certified written statements in effect giving details of the number of products sold each month. In fact the said statements were not supplied to Company X1, instead the Group accounts department each month drew up a credit note showing Company T's local and export sales figure and applied 5% thereto and came up with the royalty figure which was then credited to Company X1's account. In our opinion the absence of certified statements is neither surprising nor a sign that the agreement was not treated seriously. Since the Group accounts department looked after the accounts of both Company X1 and Company T and made its calculations of the credit notes as mentioned it is difficult to see how the rendering of certified statements could have improved matters.

It may be thought that having regard to our above findings based on the evidence of the witnesses that the outcome of this Decision was self-evident, unfortunately that is not so. Firstly because it appears to us that the success of the claim to deductions under section 16(1) depends upon criteria which are distinct from the genuineness or otherwise of the motives of the taxpayer.

‘*One must not confuse the purpose of the transaction with the motive behind it … The Court is however not concerned with the motive behind these transactions.*’ (Chan J in Wharf Properties Ltd v CIR [1994] 1 HKRC 90-073)

The matter is not however free from doubt, for Leonard J in his Court of Appeal judgement in the **Swire case** showed no hesitation in considering the motives of the taxpayer (CIR v Swire Pacific Co Ltd 1 HKTC 1145) as is clear from page 1169 of the report where after mentioning how the company was ‘influenced’ by certain matter, said:

‘*While there was only one immediate purpose – to get the workers back to work – the taxpayer was motivated by the further advantages but before those could be achieved the immediate objective had to be realised. The advantages were the reasons behind the purpose rather than the purpose itself and the purpose itself could be effected only by payment of the sum and payment of it in its entirely.*’

Mr Luk considered that so fat as sections 16(1) and 17(1)(b) are concerned we are entitled and should adopt the ‘surrounding circumstances’ approach referred to in D68/90. IRBRD. vol 5, 460 at page 479).

We propose however to ignore evidence of motive in examining whether the royalties were expended ‘in the production of profits’ or ‘for the purpose of producing profits’.

Secondly subjective motive is not material to section 61 because whether artificiality exists ‘*depends up on the terms of the particular transaction that is impugned and the circumstances in which it was made and carried out.*’ (D68/90 at page 481).

Thirdly section 61A has its own set of criteria for achieving an objective result.

7. Submissions

7.1 Propensity for mitigation of tax

Ms E was cross-examined concerning a subsidiary of Company T2 set up in 1994, after certain changes in 1993 to section 21A, to whom certain patents were transferred by Company T2. The cross-examination became bogged down due to conflicting views of the representatives as to the effect of the new law. However we think Mr Luk was inviting us to infer that that transfer and payment of royalties thereon by the Taxpayer to the subsidiary was done with an eye to tax mitigation and when that inference is coupled to the admitted fact that Company X1 was established to avoid Swiss tax then we should take a jaundiced view of the self-serving statements of the witnesses from the Group’s management - in Mr Luk’s rhetorical words -

'Is it likely that the tax benefits in Hong Kong played an insignificant role in the consideration for the company [Company T] before entering into the transactions? My suggested answer is no.'

This point bears upon credibility, as to which we have already expressed a general view, however we realize that we need to test those views against certain statutory criteria and guidelines to be found in case law. We will therefore return to this later on, but in passing merely note that his remark relates to the Taxpayer's motives.

7.2 As to Royalties and Patents:

Mr Luk appeared to us to have observed that it is impossible on decide the percentage of royalty to be charged for any application or patent which has not come into being, (meaning the applications patents which after January 1989 Company T2 hopes to make and obtain), unlike existing patents or applications the amount of the royalties for which can be determined according to various commercial factors. We may have misunderstood Mr Luk because the obvious answer to the observation is that royalties are charged on sales, not per application or per patent, so naturally a non-existent patent or application can have no impact on sales.

It was also suggested by Mr Luk that Company T should have attempted to put a price on each existing patent and should have somehow arranged to recompense Company T2 (through Company X1) for its future R&D work. We think the suggestion is impracticable. If Company T2 and Company X1 had indeed been outsiders, we think that the arrangement they would have negotiated with Company T would be very much along the lines of the 5% royalty on Company T's sales regardless of whether those sales might in the event turn out to be attributable to existing patents, future patents or a mixture or exclusively to any given patent or application. The problem of attribution is too elusive and convoluted to warrant any such mathematical approach. In seems to us that the only reasonable approach to fixing the royalty in the type of business we are here concerned with (where several patents of varying lifespans can appear in one electrical component) is to relate it to the user's sales, that then leaves only the amount of the percentage to be determined. Since we have said (6.9.2) the chosen figure appears to us to be quite reasonable it calls for no further comment.

Mr Luk suggested the fact that patents were abandoned by Company T2 in the course of the next few years was indicative that the importance the Taxpayer professed to place on the patents was not genuine : with respect the suggestion is a non sequitur; there any many reasons for abandonment, not least of which is the arrival of new technologies which make it uncommercial to maintain a patent which has become commercially redundant. Moreover we understand the UK patent annual renewal fees increase the longer the patent is kept in force, presumably to induce a patentee to give up his monopoly.

Next Mr Luk implied that the catalogue of patents and applications filed by Company T2 after January 1989 were not the result of Company T2's work, meaning that he doubted that Company T2 was seriously involved in R&D work. We have accepted Dr H's evidence; hence we reject this implication.

He then went on to speculate that most of the 51 patents and applications registered by Company T2 between January 1989 and September 1991 originated from the transferred patents. Even if it were true that 'most' did so originate and were so used there was no evidence which would clearly show that these represented the greatest value to Company T with respect to the electrical components which it sold during the said period or even whether the improvements were of more or less value than the transferred patents. As we understand matters certain electrical component innovations resulted directly from Company T2's own efforts and we gained the impression that those particular innovations made a considerable contribution to the X Group's fortunes. Company T2 held two patents before 1 January 1989, we do not know their importance nor what number (if any) of the 51 Patents stemmed from those two patents or how influential they were in the sale of the electrical components.

Mr Luk compares Company T2's R&D total expenditure 1988/89 to 1991/92 of $63,131,799 with the $166,149,464 total of the royalties paid to Company X1 by the Taxpayer over the same period. However we think the difference can be narrowed to about $3 million because the R&D expenditure does not include the $100 million consideration for the patents, without which the comparison is fallacious.

7.3 Sale & lease back

The Revenue characterized the sum of Transactions 1, 2 and 3 as a 'sale and lease-back'. We do not think that is accurate because (a) the patents were sold to Company T2, yet the sub-licence came from Company X1 and (b) the sub-licence included patents which were not part of the sale.

7.4 Onus of proof

Mr Luk not only referred to section 68(4) but also to a passage in D68/90 to the effect that the Taxpayer had to satisfy the Board that section 61 has been wrongly applied, we think this is also true of section 61A.

7.5 Arm's length transactions

The Revenue challenge the assertion that the impugned transactions were 'arm's length'. Clearly they could not be arm's length in the accepted sense of dealings between unconnected parties, but that of itself does not mean it is artificial nor is it indicative of tax avoidance. The Stamp Duty Ordinance at section 45 recognizes the commercial validity of deals between connected persons. The real test is whether such a deal conforms with what one would expect in a similar deal between unrelated parties.

We will now address the three main issues.

FIRST ISSUE - deductibility of the royalties

This is concerned with sections 16(1), 17(1)(b) and 16B(1)(b).

Section 16(1)

'In ascertaining the profits in respect of which a person is chargeable to [profits] tax … there shall be deducted all outgoings and expenses to the extent to which they are incurred … by such person in the production of profits in respect of which he is chargeable to tax …, including'.
[the inclusive paragraphs are inapplicable]

Section 17(1)(b)

'For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part on deduction shall be allowed in respect of -

> *(b) any disbursements or expenses not being money expended* ***for the purpose*** *of producing such profits…'*

Section 16B(1)(b)

'… in ascertaining the profits from any trade or business in respect of which a person is chargeable to tax … there shall, …, be deducted the following payments made, and expenditure incurred, by such person during the basis period …, namely -

> *(b) expenditure on scientific research related to that trade or business, including capital expenditure …'*

Double Benefit

This submission runs as follows. For the two years 1987/88 and 1988/89 before the patents transfers, Company T claimed and was granted by the Revenue deductions for capital and revenue expenses pursuant to section 16B(1)(b). Having obtained those tax benefits Company T then not only transferred the patents which were the tangible results of its R&D efforts but also had the effrontery to claim the royalties it thereafter had to pay for the use of those patents.

The following is an attempt to paraphrase what we take to be Mr Luk's point. Logically it cannot be said that the royalties were paid for the **purpose** of producing profits (section 17(1)(b)) because that **purpose** had already been satisfied by Company T's own pre-transfer R&D work, the costs of which were allowed in full as deductible under section 16B(1)(b). It follows that those costs and their purpose had been exhausted, accordingly as in reality the royalties are the same R&D costs in disguise they cannot meet the 'purpose' test in section 17(1)(b).

It seems to us that this argument must fail. First the royalties cannot be equated to or, because of the large number and different lifespans and importance, have any measurable correlation with the R&D costs; the royalties are based not on R&D costs but on sales which, as Mr Luk pointed out in another context, could in theory be insufficient to meet Company T2's R&D costs – including the $100 million cost of acquisition of the subsisting patents. Secondly even if, for the sake of argument, we were to accept that the transferred patents played some part in the production of post transfer profits it is impossible, due to the diversity mentioned above, to attribute any given proportion to the part played : we have dealt with this point at 7.2 above in rather different terms when addressing Mr Luk's speculation concerning the 51 new patents. But as Mr Houng-Lee pointed out even if it were possible to attribute a proportion there is nothing in sections 16 or 17 of the Ordinance which would justify denying the deductions. Thirdly if Company T2 had transferred to a third party from whom it received a licence back we cannot see on what grounds the royalties deductions could be refused. If this reasoning is correct then the double benefit proposition in essense depends upon a finding of artificiality or tax avoidance in which event, argument concerning section 16(1) is in our estimation irrelevant.

We have to say that we have considerable empathy for the Revenue's attitude, it seems however to be based on equity or fairness. As to which it is a well-known that moral precepts are not applicable to the interpretion of revenue statutes (Mangin 1971 AC 739).

Be that as it may neither the Commissioner nor Mr Luk cited any case law or statutory provisions prohibiting a double benefit, outside the context of sections 61 or 61A. Mr Luk referred to <u>D68/90</u> (page 479) as authority for looking at the surrounding transactions – not merely the Company X1/Company T sub-licensing agreement – in deciding if the expenditure was 'for the purpose of producing' chargeable profits (section 17(1)(b)). He then went on to argue that since it is obvious Company T sold its existing patents with every intention to use them in the future, there could be no commercial justification for incurring the royalties. Now it seems to us that this argument cannot succeed without at the same time reaching the conclusion that the transaction itself is artificial, that is, that section 61 is invocable. If such is the case then the question of deductibility will never arise because if it is invoked the transaction on which the deductibility depends will be disregarded. We therefore believe that in cases where a transfer of the kind before us is untainted by circumstances which would justify applying sections 61 or 61A, as for example if patents for some commercial reason (entirely unconnected with tax avoidance) were sold **to a third party** and licensed back in return for royalties, then even if the seller were to have had obtained the benefit of section 16B(1)(b) before the sale there is nothing in our tax law to make the deduction under section 16(1) of the royalties involved objectionable from a tax standpoint.

Put another way had Company T been obliged to sell to a third party it would have still enjoyed the benefit of the sale proceeds, quite possibly payable over four years, as well as having to pay the royalty. We think that in such a truly arm's length deal though Company T lost ownership of its patent, 5% of its sales returns would be a small price to pay for securing lasting future R&D work of a kind it was unable to carry out in Hong Kong.

If, as we believe, we are correct in the last analysis it follows that the Revenue's argument regarding section 16(1) (as read with section 17(1)(b)) has no real bearing so long as it can be said that the royalties were incurred in the production of chargeable profits. In a way the Revenue appears to be saying that because the transactions were either artificial or the dominant purpose was tax avoidance it follows that the royalties are not deductible under section 16(1); however we think that sections 61 and 61A have consequences independent of section 16(1), namely under sections 61 and 61A(2)(a) ignoring the transactions concerned or under section 61A(2)(b) in such other manner considered appropriate.

We accept Mr Houng-Lee's argument that the royalty is the quid quo pro not merely for use of the patents Company T transferred but also for **future** patents and applications. In out estimation it is also reasonable to suppose that the transferred patents would gradually become outdated which would make the new patents relatively more valuable.

We therefore find for the Taxpayer on this first issue.

SECOND ISSUE - artificiality and section 61

This section reads:

> *'Where an assessor is of the opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessable accordingly.'*

The Commissioner and Mr Luk have focussed the Revenue's argument on the word 'artificial': there is no suggestion that the transactions were 'fictitious'. Reference was made by Mr Luk to an observation of Lord Diplock in Seramco case (Seramco Ltd Superannuation Fund Trustees v ITC [1976] STC 100), that whether a transaction can properly be described as 'artificial' depends upon the terms of the particular transaction that is impugned and the circumstances in which it was made and carried out, and the observation by Cons J (as he then was) in **Howe's case** (CIR v Douglas Henry Howe HKTC 936) that a 'commercially unrealistic' transaction comes within the meaning of 'artificial'. The Revenue's line is that the following aspects (with our comments) show that Transactions 1, 2 and 3 are commercially unrealistic:

(1) The Taxpayer sold its principal assets while still actively engaged in manufacturing and trading. Comment: the purpose however was to put those assets beyond the reach of expropriation.

(2) The Taxpayer was well aware that neither Company T2 nor Company X1 had the money to pay for the patents, consequently a circular scheme was set up. Comment : assuming one accepts the Taxpayer first concern was to put the patents beyond the reach of expropriation then the financing technique adopted (including payment of the purchase price by set off against a percentage of profits) is no more artificial than it would be if Company T2 had been a total outsider and though Company T2 could not pay cash for the patents that would not in our estimation rob such a hypothetical arm's length deal of its commerciality. In many takeover bids the buyer is unable to produce the price from its own resources, it simply proposes to use the assets or cash flow of the target company. As to circularity of payment the presence of a 'round robin' system generally leads to adverse prima facie inferences: it was a contributing factor in D68/90 and D44/92. In our case the payment of the $100 million price was drawn from the royalties over four years, but the important distinction is that the royalties also went to pay for patents and applications made after 1 January 1989. The point can be made in another way : suppose that on 1 January 1989 Company T2 had not taken over Company T's patents but Company T2 nevertheless was the focus of generic R&D work with the laboratories and workshops and staff it had at the relevant time, using Company T in the same role allotted to Company X2 and Company T continuing as the registered owner of the post 1 January 1989 patents. In such a situation Company T2 would have had to be funded by Company T, who would also have to pay the registration fees. That funding would not qualify under section 16B(1)(b) but why should it not qualify for deduction under section 16(1)? We can think of no grounds for disqualification, it would certainly have been spent for the purpose of producing profits for Company T so section 17(1)(b) would not apply.

(3) The $100 million loan made to Company X1 by Company T (following the debt assignment) was interest free repayable over four years without security. Comment : experience indicates that loans between related companies, particularly where they are wholly owned, are common and, unless there is some dubious motive, acceptable from an accountancy viewpoint.

(4) The $100 million was not fixed by reference to any independent valuation. Comment: we have accepted that such valuation could not be obtained and believe the figure adopted was bona fide and reasonable.

(5) The Taxpayer gave away its valuable patents not only free but at a loss. Comment: the evidence, which we have accepted, shows that during the four years in question Company T was out of pocket by about $3 million only in return for which it kept 95% of its sales returns, and an unquantifiable amount of those was attributable to the innovations (in excess of 51) developed by Company T2 after 1 January 1989.

(6) Over the relevant four years the annual royalties, $166,149,464, exceeded Company T2's R&D costs, $63,131,799, by a wide margin, that is, $103 million odd. Comments: $100 million of the latter figure can be said to relate to the patents sale, thus leaving a net $3 million which as noted above enabled Company T to retain 95% of its sales.

Mr Luk submits that the question (under section 61) is whether there is any real commercial benefit to **the Taxpayer**, not Company T2, Company X1 or any other company. If one accepts that the aim of the entire scheme of arrangement and transactions was asset protection then by placing the patents off-shore **Company T's own use** of them is preserved because the possibility of expropriation or their becoming ineffective or valueless due to the absence of a satisfactory legislation is avoided. We can therefore see quite clearly the commercial benefit to Company T. We quite appreciate that in 1989 those risks were some years away (Mr Luk suggested that the off-shoring was 'premature') but as Mr I pointed out if Company T continued to apply for patents then the expense of transferring them, say in 1977, might well be much greater. There was therefore also an expense saving benefit.

That Company T2 is to receive no profit from its head licence to Company X1 appears at first uncommercial but as that arrangement avoids Swiss withholding tax it is financially advantageous for the Group and hence commercially expedient. Naturally (as Mr Luk commented) if Company T2 and Company X1 were not associated then Company T2 would not enter into the transaction, but if that hypothetical situation had existed then its conceivable that the question of 30% withholding tax would not have arisen. The facts are that Company X1, Company X2 and Company T are associated and the test of commerciality should be viewed in that context.

The conclusion we have reached regarding section 61 is that in the circumstances in which the transactions were made and carried out, including particularly the registration in the various patent offices of the assignments whereby formal title was transferred as a matter of public record. Transactions 1, 2 and 3 were commercially realistic and not artificial and the financial schemes thereby established are of the kind which would not be farfetched had the transactions taken place amongst unrelated parties.

THIRD ISSUE - tax avoidance and section 61A

This is the provision which seems to represent the real nub of the objections to the deduction of royalties. Given the amount of tax at stake, it is not surprising that the Revenue should look at the transactions from which the royalties are derived with special care.

The following, slightly abbreviated and with our emphasis added, is the text of subsections (1) (2) & (3) of this section. The Inland Revenue Department's views on section 61A are to be found in Departmental Interpretation & Practice Notes No 15 (Revised), which we shall refer to as Note 15. The seven extracted paragraphs (a) to (g) appear later with respective submissions.

'*(1) This section shall apply where any* ***transaction*** *has been entered into or effected 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:*

> … [Here follow the said seven paragraphs]…
>
> … 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 person, to obtain a **tax benefit**'

Subsection (3) contains the following definitions:

' *"tax benefit" means the avoidance or postponement of the liability to pay tax or the reduction … thereof;*

"transaction" includes a transaction, operation or scheme whether or not … enforceable, intended to be enforceable …'

The consequence of a tax avoidance conclusion under (1) is that an assistant commissioner can pursuant to subsection (2) 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.'*

Note 15 interprets the words 'it would be concluded' as implying that section 61A 'will only be applied in cases where the sole or dominant purpose is clearly evident.' The

Note also states that the Revenue takes the view that 'the conclusion is an **objective one** to be drawn on the basis of the **external features** of the transaction viewed in their proper context' (our emphasis, which we think lends weight to adoption of the wider interpretation which, to make the distinction, we refer to below as 'the Scheme').

Two preliminary questions need answering. Was there a transaction? If so did it enable Company T to obtain a tax benefit?

Identifying the Transaction

Mr Houng-Lee submits that contrary to the line taken by the Commissioner the transaction begins with the circular to shareholders setting out the Scheme and ends with the transfer of the patents and the concomitant licences and Service Agreement. Certainly the Assistant Commissioner did not focus **solely** on Transaction 3 when he invoked section 61A which is the only one from which Company T has the potential to derive a tax benefit. In consequence of Transaction No 1 Company T loses future section 16B(1)(b) tax allowances, hence it confers no tax benefit. Company T is not a party to Transaction No 2 – which also does not confer any tax benefit on Company T. It would seem therefore that the Assistant Commissioner has treated all three Transactions 1, 2 and 3 as a single scheme or operation when reaching his conclusion.

Mr Houng-Lee reminded us (a) that Mr A's letter contains the assertion that as part of the reorganization 'this subsidiary [Company T2] will hold the Group's patents' which can be seen as the **prelude** to Transaction No 1 and (b) that the recitals to the Transaction No 1 agreement and the Company T2/Company X2 Service Agreement indicate that those agreements are **in furtherance** of the reorganization referred to the circular. Both these points, as well as the reference to 'background' in paragraph (a) below, in our opinion justify a wider interpretation than that used by the Assistant Commissioner.

For our part we can see no reason why the Court proceedings under section 166 of the Companies Ordinance, the circular to shareholders – composed of Mr A's letter, the explanatory statement, the scheme of arrangement, appendices and notices convening the Court meeting and an EGM – observance of Bermuda regulations, the said meetings in 1988, the petition for the Company X Act 1988, reduction of capital, cancellation of shares, increase of capital, allotment of fully paid shares to Company X, delisting and listing afresh of Company X's shares should not all be treated for the purposes of section 61A(1) as much an integral part of the 'operation' or 'scheme' as Transactions 1, 2 and 3. Our reference hereafter to 'the Scheme' includes all of the aforementioned plus the Promissory Note, Transactions 4 and 5 and the Assignment of debt.

Mr Luk responds to the wider interpretation approach by citing certain passages from the Australian **Peabody's case** (<u>FCT v Peabody</u> 24 ATR 58 and 28 ATR 344) from which he concludes that even though the judge in first instance was prepared to accept that the public flotation in question was a commercial arrangement and that there was a genuine need to avoid disclosing in the prospectus certain facts which it was thought by him to have tax implications he nevertheless gave those facts 'closest examination' and dismissed the taxpayer's appeal. The taxpayer then appealed to the Full Court of the Federal Court which found in her favour. The Commissioner then appealed to the High Court which again found in her favour because there was no convincing evidence that she would necessarily receive a tax benefit – which result is said by Mr Luk and tax commentaters to be owned to a 'technicality', though with respect it appears to us to be due to the lack of a fundamental prerequisite. The High Court did however say –

> *'But PART IVA [the Australian Anti-avoidance provisions] does not provide that a scheme includes part of a scheme and it is possible, despite the very wide definition of a scheme, to conceive of a set of circumstances which constitutes only part of a scheme in itself. That will occur where the circumstances are incapable of standing on their own* ***without being robbed of all practical meaning****.'*

As Mr Houng-Lee said the Court did not elaborate on the underlined expression. Certainly it seems to us that Transaction 4 is required to give practical meaning to the first three Transactions – that is, Company T2 needs Company X2's services. Mr Luk quite fairly produced articles on the Peabody decisions of which these two extracts from one commentator (Robert Richards in December 1991 issue of Australian Accountant) present a good reason for not confining ourselves to the narrower interpretation:

> *'Unfortunately that does not mean that we understand Part IVA – the Courts have yet to tell us what it means.' and 'Rather, I suggest, the High Court will have no choice but to decide how Part IVA interacts with otherwise clearly commercial transaction.'*

Before we could have accepted Peabody as persuasive authority we would have needed to hear a full explanation of relevant Australian law and the reason why a part of the overruled Federal Court judgement should be accepted. Accordingly we are unconvinced that the wider interpretation is inappropriate.

On this subject we are a little surprised that the Revenue is unwilling to concede the validity of the wider interpretation since it is particularly common in the interpretation of facts having tax implications for account to be taken of all the surrounding circumstances: Mr Luk urges it with regard to section 16(1). Generally therefore a given fact is examined in the context in which it is found. We inter from the evidence and find as a matter of fact that the Scheme constituted a single composite operation, wherein the whole was greater than the sum of its parts, that at the moment the circular was published those parts (including specifically Transactions 1, 2 and 3) were pre-ordained with little expectation that they would not materialize.

Tax Benefit

As Mr Houng-Lee accepts that Company T would enjoy a tax benefit in the shape of the deduction of the royalties from its chargeable profits but he maintains that benefit was an incidental result and not the sole or dominant purpose. As to the actual worth of the benefit see comments regarding paragraph (c) and submissions by Mr Houng-Lee on the application of paragraphs (a) and (b).

With the wider interpretation in mind [and hence the transposition of 'Scheme' for 'transaction' in the following extracts] we now pass to matters to which 'regard' should be had. The words in square brackets after the dash are taken from Note 15.

(a) *'The manner in which the Scheme was entered into or carried out – this matter relates to the background of the Scheme and the alternative purposes which could be attributed to the purpose(s) entering into it.'*

In our opinion the background to the Scheme is the political pessimism which we have already acknowledged to have existed, the wariness of the A family, the realization of the worth of patents, the concern for Hong Kong' patent system, the perceived needs for sophisticated R&D and internationalisation. We find therefore that virtually the sole **purpose** (aim, intention) of the Scheme was to resolve those concerns.

Mr Luk notes that the numbered transactions were all between related companies, in our opinion that is almost always the case with Group reorganisations and redomiciliations. He also comments on Company T2's lack of cash, but as we have already remarked we do not think that is questionable of itself – it is common enough in reorganisations and takeovers. The 'manner' involved observance of company laws, stock exchange regulations, and shareholder and judicial approvals, all factors which we think weigh in the Taxpayer's favour (notwithstanding Peabody, where it should be noted the taxpayer in the flotation concerned was out to mislead the stock exchange authorities and potential applicants for shares – which is not so in the case before us).

(b) *The form and substance of the Scheme – form refers to the legal rights and obligations created by a Scheme; it is the legal effect of the Scheme. Substance on the other hand means the practical or commercial end result of a Scheme as opposed to its legal effect. In considering this matter it is necessary to compare the legal effect of the Scheme with its commercial end result.*

Mr Luk confines his comments to the narrower interpretation of 'transaction' and says the legal results were that Company T ceased to be the patentee (Transaction 1), instead as a sub-licensee it had to pay for the use of the transferred patents (Transaction 3). The commercial result was disposal of 'its most valuable assets not only for free, but at a loss, moreover Company T had no immediate use for the sale proceeds'.

Mr Houng-Lee examines this factor 'objectively' from the perspective of the wider interpretation and notes that the Scheme results in the Group's holding company being domiciled in Bermuda, which in International Law gives a measure of asset protection, that the patent transfer and transfer of Company T2 shares were done for asset protection, that the licences enabled Company T not only to continue to us **subsisting** patents but also Company T2's future ones. All of which **legal** results are consistent with his submissions that viewed objectively asset protection was the dominant purpose of the Scheme. We agree entirely with his analysis and conclusion. As to commercial end result we think it virtually tracks the legal rights and obligations though Mr Houng-Lee adds some comments about how the transfers also enhance the Group's enforcement potential; that however seems to be simply another branch of asset protection.

(c) *The result which [ignoring this section] would be achieved by the Scheme – this relates to the result which would arise out of the operation of the … Ordinance, excluding the possible application of section 61A, and involves a comparison with the result would arise if the Scheme had not been entered into.*

[This is referred to at 24 of Note 15 as the '**tax consequence criterion**']

Mr Luk says that Company T, instead of being the owner, becomes a sub-licensee of the patents paying royalties for their use. That argument ignores the fact that the royalties are charged on sales of the electrical components which are increasingly likely to depend upon future rather than subsisting patents. In our opinion the **tax result** immediately following implementation of the Scheme is that Company T loses its section 16B(1)(b) deductions but instead would be able to deduct royalties, ($166.1 million over four years) under section 16(1). If one equates (subject to the remark about subsidies below) the cost and expenses which Company T2 charges to Company X1 ($63.1 million) with the R&D costs which Company T would have incurred the difference is narrowed to $103.1 million from which $100 million is deducted being the amount paid over four years to Company T by Company X1 (that such payment was effected by set off does not alter the fact that it was a payment received by Company T) thereby reducing the tax advantage to $3.1 million.

Another tax result is that Company X2 pays tax on its profits from the 110% which it charges to Company T2. This is the appropriate paragraph to bring this aspect into account because, unlike paragraph (d), 'result' is not confined to the relevant taxpayer. Account should also be taken of the tax which Company X1 has to pay under the old section 21A on 10% of the royalties it receives.

(d) *Any change in the financial position of the* ***relevant taxpayer*** *arising out of the Scheme – This matter compares the financial position of the person after the Scheme has been entered into with that which would have existed had the transaction not been entered into.*

The approach of the respective representatives to this factor is interesting. Mr Luk put it this way – before the transaction Company T incurred section 16B(1)(b) R&D expenditure amounting to about 2.79% and 2.46% on sales for 1987/88 and 1988/89 respectively, afterwards however there is no expenditure by Company T on R&D but instead it incurs 5% on sales and its patents rights have been replaced by an interest free loan repayable by setting off royalties.

Mr Houng-Lee says the objective facts are that over four years Company T received $100 million and paid royalties of $166.1 million for which it claims a section 16(1) deduction. Superficially therefore Company T is out of pocket $66.1 million but from that should be deducted Company T2's R&D expenses of $63.1 million leaving $3 million as the real out of pocket cost to Company T over four years for which it gets the use of future patents.

We can quite clearly see there has been a change in Company T's financial position, but much of that change is due to the cessation of its previous R&D work some of which was taken over by Company X2, the remainder becoming superfluous due to the accelerated emphasis on Company T2's sophisticated R&D work. Though these changes **for Company T** may not entirely outweigh the said $3.1 million they minimize that advantage very considerably.

(e) Any change in the financial position of a person who has any connection with the **relevant taxpayer** arising out of the Scheme – *in contrast to (d) which refers to the financial position of the taxpayer, this matter focuses on the* ***change*** *in the financial position of any person connected with the Scheme.*

Company T2's position changes dramatically after the reorganisation because of the new emphasis upon Company T2 as the heart of R&D work and patent registration and though Company T2's own financial position is neutral when Company X1 is looked upon as its financial arm then the combined financial benefit has nothing whatever to do with Hong Kong tax. We recognise however that as Company X1 and Company X2 did not exist before the Scheme there can be no 'change' for them.

(f) *Whether the transaction has created rights and 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 – this test looks at the rights or obligations created by the transaction (in contrast to (a) above which looks at the method or manner in which it was entered into or carried out). The actual rights and obligations created are to be compared with those that would normally be created under a similar transaction carried out at arm's length. In making this comparison due regard must, of course, be given to the surrounding circumstances.*

Of this paragraph and paragraph (g) Note 15 says 'where they are present [they] can be relevant as an indicator of a purpose of obtaining a tax benefit;

they are not however, conclusive.' We also realise that the narrower interpretation of transaction is more appropriate here.

Mr Luk says the 5% royalty was 'grossly excessive', we do not agree preferring the evidence of professionals in the field (Messrs C and B), the percentages referred to in the three patent reports and the evidence of the German joint venture which uses the same percentage. Granted he is comparing the 5% with R&D expenses but as Mr I said 'there is no absolute link between royalty rate and the cost of development' which for us make sense. He also feels the $100 million to be 'extremely conservative', we think not and have already given our reasons.

Mr Houng-Lee acknowledged in effect that Transaction 1 was unusual but reminded us that Mr C had mentioned hearsay knowledge of transactions between unrelated parties and Mr B was aware of liquidators' sales of patents.

For our part if Transaction No 1 had taken place between unrelated parties we do not think it too fanciful to suppose that the sum effect of the rights and obligations (save for the need to include Company X1) would be any different from the sum effect of Transactions 1, 2 and 3.

(g) *The participation in the Scheme of a corporation resident or carrying on business outside Hong Kong.*

All we need to say about this is that if asset protection for shares and patents was indeed at the heart of the Scheme then the participation of non Hong Kong companies was a sine qua non.

In case we are wrong to adopt the all-embracing 'Scheme' we have re-examined the criteria with the narrower interpretation in mind. Paragraph by paragraph the result is:

- (a) & (b) Note 15 at 24 says these 'are in the nature of items that form a background picture to the transaction and help to set the scene', consequently the wider definition is acceptable.

- (c) Our remarks were made without reference to the wider interpretation because of the reference to 'tax consequences': Company X2 and Company X1 are parties to transactions in the narrower sense, so their inclusion is not inappropriate.

- (d) & (e) Our remarks were made on the basis of the narrower view because of the reference to 'relevant taxpayer'.

- (f) Again our remarks are made on the basis of the narrower view.

- (g) The protection of the patents from expropriation and the uncertainty of Hong Kong's patent system presupposes the transfer of title to a non Hong Kong entity.

In our opinion none of Transactions 1 to 5 inclusive was a 'fiscal nullity'. The latter phrase refers to any arrangement which has no objective economic reality and is designed to return all parties within a short period to their original positions.

It therefore follows that taking an objective view of the 'transaction', whether in the wider or narrower sense, we are of the opinion that it would not be concluded that the sole or dominant purpose was to enable the Taxpayer, Company T, to obtain a tax benefit. The Scheme was not or the impugned transactions were not in our opinion 'blatant or contrived arrangements' which, as mentioned in Note 15, section 61A should 'strike down'. Mr Houng-Lee suggests that the tax benefit was incidental and we are inclined to agree. Though perhaps not strictly relevant, having seen and heard the witnesses and had the benefit of studying contemporary documents we have no doubt that Mr D, Ms E and Mr I were quite sincere in their expressed belief that to leave existing patents and the role of applying for future patents in Company T's hands was to run an unacceptable risk and that the transfer to Company T2 was not only the best safeguard but was complementary to Company T2's R&D role.

Though other cases were cited we have considered them but do not feel they call for any comment from us. They were Ensign Tankers (Leasing) Ltd v Stokes [1992] STC 226), CIR v Lo & Lo [1984] 1 WLR 986, Fletcher & Others v FC of T 91 ATC 4950, CIR v Challenge Corporation Ltd [1986] STC 548, D52/86, IRBRD, vol 2, 314 and D20/92, IRBRD, vol 7, 166.

8. CONCLUSTION

As we have already expressed our opinions on each of the three issues the following mainly serves as summary.

Section 16(1)

The royalties qualify for deduction from chargeable profits because there are no grounds for refusing deductibility under this section or under section 17(1)(b).

Section 61

The Scheme and the ancillary Transactions 1, 2 and 3 were not artifical, this section has therefore been wrongly applied.

Section 61A

We would not conclude the sole or dominant purpose of the Scheme or the said ancillary transactions was to obtain a tax benefit.

This appeal is therefore allowed.

The Board would like to record our thanks to the respective representatives for the very professional manner in which they presented their respective positions and our appreciation of the helpful way in which the Taxpayer's arguments were carefully cross-referenced to statements and to the numerous exhibits.