Case No. D97/04

Profits tax – whether interest on borrowing deductible – circular borrowing transactions within group of companies – whether transactions for the sole or dominant purpose of obtaining tax benefit – whether artificial or fictitious – Inland Revenue Ordinance ('IRO') sections 61 & 61A.

Panel: Ronny Wong Fook Hum SC (chairman), Eric T M Kwok SC and Andrew Li Shu Yuk.

Dates of hearing: 28, 29, 30 October and 1, 2, 4, 5, 6 November 2004.
Date of decision: 21 March 2005.

The appellant in this appeal is Company P.

At all material times, Company I, H, P and S belonged to a group of companies.

In November 1994, Company I purchased from Company H its port business for HK$23,000 millions. As a result, circular borrowing transactions involving various companies within the group were carried out. In particular, Company P issued interest bearing notes which was guaranteed by Company I to Company S. Company P then lent the proceeds of the notes to Company I for the purchase of the port.

In computing its profits, Company I deducted the interest purportedly payable to Company P including the part of the interest payable for the notes held by Company S.

Held:

1. The Board found the transactions conferred a tax benefit on Company P. It consisted of reduction of tax by ostensible payment of interest on Company S notes (Mangin v Inland Revenue Commission distinguished; Cheung Wah Keung v Commissioner of Inland Revenue followed).

2. The Board found the borrowing by Company P from Company S was for the dominant purpose of enabling Company P to obtain a tax benefit under section 61A of IRO (Yick Fung Estates Ltd v Commissioner of Inland Revenue applied). Thus, the borrowing should be disregarded and the interest paid on the Company S notes so disallowed.

3. The Board also held that the borrowing by Company P from Company S was artificial and fictitious as no real money ever changed hands under section 61 of IRO. Thus, Company S notes and the interest paid on it should be disregarded. (Seramco Superannuation Fund Trustees v Income Tax Commissioners applied).

Obiter:

The Board did not think it necessary to rely on the Ramsay principle (Furniss v Dawson; Shui Wing Ltd v Commissioner of Estate Duty; Collector of Stamp Revenue v Arrowtown Assets Ltd considered).

Appeal dismissed.

Cases referred to:

The Commissioner of Taxation of the Commissioner of Australia v Peabody [1994] 181 CLR 359
Mangin v Inland Revenue Commissioner [1971] AC 739
Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773
Yick Fung Estates Ltd v Commissioner of Inland Revenue [2000] 1 HKLRD 381
Commissioner of Inland Revenue v Hang Seng Bank Ltd [1991] 1 AC 306
Seramco Superannuation Fund Trustees v Income Tax Commissioners [1977] AC 287
Furniss v Dawson [1984] AC 474
Shui Wing Ltd v Commissioner of Estate Duty (2000) 3 HKCFAR 215
Collector of Stamp Revenue v Arrowtown Assets Ltd (2003) HKCFAR 517
Barclays Mercantile Business Finance Ltd v Mawson (Her Majesty's Inspector of Taxes) [2004] UKHL 51
Her Majesty's Commissioner of Inland Revenue v Scottish Provident Institution [2004] UKHL 52

David Goldberg QC and Mr Stewart K M Wong instructed by Department of Justice for the Commissioner of Inland Revenue.
John Gardiner QC, Mr Ambrose Ho SC and Mr Kenny Lin instructed by Messrs Woo, Kwan, Lee & Lo for the taxpayer.

Decision:

The appeal

1. This is one of three appeals lodged by the Appellant and its related companies from the determinations of the Commissioner in relation to each of them respectively all dated 30 May 2003. The tax assessments raised on the Appellant and its related companies are alternative assessments. By consent directions endorsed by the Board on 22 July 2004, the Appellant's appeal and the appeals of its related companies are to be heard by the same panel consecutively, commencing with the appeal of the Appellant.

The Appellant and its related companies

2. Company A:

(a) In 1977 Company B merged with Company C to become Company A.

(b) Company A is a company listed on the Hong Kong Stock Exchange. As at 22 September 1993, 3,616,882,378 shares were issued. At the then market price of HK$23.1 per share, the market capitalisation was HK$83,549,982,932. The number of issued shares was increased to 4,263,370,780 by 22 September 2004. At the then market price of HK$62.5 per share, the market capitalisation was HK$266,460,673,750.

(c) Company A is the ultimate holding company of the entities referred to hereunder.

3. Company D

(a) This was created on 27 April 1993 in the name of Company E.

(b) It was incorporated as the holding and management company responsible for all the interest of the Company A Group in ports in Hong Kong, China and overseas.

4. Company F

(a) Company F was incorporated in Country CA in the name of Company G on 26 July 1994.

(b) It is the immediate holding company of Company H. It acquired the shares of Company H on 25 November 1994.

5. Company H

(a) Company H was incorporated in Hong Kong on 28 June 1974 in the name of Company I. It was incorporated as a subsidiary of Company B.

(b) Prior to the re-structuring in 1994, the shares of Company H were held:

(i) As to 77.5% by Company J which was a wholly owned subsidiary of Company A.

(ii) 22.5% by five independent minority shareholders including Company K, Company L, Company M, Bank N and Group O.

(c) It changed its name to Company H on 28 November 1994.

6. The Appellant Company P

(a) Company P was incorporated as a private company in Hong Kong on 3 March 1994 in the name of Company Q. It changed to its present name effective from 2 June 1994.

(b) It has an initial authorised share capital of HK$10,000 dividend into 1,000 shares of HK$10 each. Two shares have been issued and fully paid-up and are beneficially owned by Company H.

(c) It commenced to carry on business on 27 May 1994. Prior to its involvement in the transactions which are the subject matter of this appeal, Company P carried on no business whatsoever. In its profits tax returns for 1994/95 to 2000/01 it described the nature of its business as 'financing'.

7. Company I

(a) Company I was incorporated in Hong Kong on 3 March 1994 in the name of Company R. It changed to its present name effective from 28 November 1994.

(b) Its initial authorised capital was HK$10,000 dividend into 1,000 shares of HK$10 each. Two shares have been issued and fully paid up and are beneficially owned by Company H.

(c) Prior to its involvement in the transactions which are the subject matter of this appeal it carried on no business whatsoever.

8. Company S

(a) This was incorporated as a private company in Country CA in the name of Company T on 7 March 1994. At all material times, the ultimate holding company of Company S was Company A.

(b) It changed to its present name on 4 August 1994.

The sale and purchase agreement of 28 November 1994 ['the Port Purchase Agreement']

9. Pursuant to the Port Purchase Agreement, Company I purchased from Company H the assets employed in or relating to the business formerly carried on by Company H at Container Port Terminals XX, YY and ZZ ['the Port'] in District U together with the other assets and subject to the liabilities of that business for a purchase price of HK$23,000,000,000. Clause 3 of the Port Purchase Agreement provided that the consideration of HK$23,000,000,000 was to be paid in the following manner:

(a) HK$10,394,275,824 'shall be payable forthwith by [Company I] to [Company H] upon [Company I] receiving from [Company H] written demand to pay the same'.

(b) HK$6,100,000,000 shall be payable by Company I issuing an interest free subordinated loan note in that amount to Company H.

(c) HK$6,505,724,176 shall be payable by Company I to Company H in the form of a back to back loan note whereby Company I undertook to pay interest and capital to Company H sufficient to enable Company H to pay and repay banks on borrowings which it had incurred.

10. Clause 4 of the Port Purchase Agreement provided that completion shall take place on 28 November 1994 or such later date as the parties may agree in writing prior to completion. Clause 6 of the Port Purchase Agreement further provided that following completion, this Agreement shall be deemed to take effect from the start of business on 1 June 1994.

11. Annexed to this decision as Appendix I and Appendix II are organisation charts relating to the Port prior to and after the Port Purchase Agreement.

The issue of the Notes

12. On 28 November 1994, Company P issued guaranteed floating rate notes ['the Notes'] listed on the Stock Exchange in Country V with a face value of US$1,735,000,000. At the then rate of exchange, US$1,735,000,000 was the equivalent of HK$13,400,000,000. Interest was payable on the Notes at the rate of 0.85% p.a. over six months LIBOR. Such interest was payable semi-annually in arrears on 28 May and 28 November in each year commencing on 28 May 1995. Subject to earlier redemption, the Notes were due to mature 10 years from the Issue Date (28 November 2004). The due and punctual payment of principal and interest in respect of the Notes were unconditionally and irrevocably guaranteed by Company I and irrevocably guaranteed by another associated company, Company W to the extent of HK$500,000,000.

13. The issuance of the Notes was effected by the following documents:

(a) A Listing Memorandum dated 23 November 1994.

(b) A Subscription Agreement dated 23 November 1994.

(c) An Agreement Among Managers dated 23 November 1994.

(d) A Fiscal Agency Agreement dated 28 November 1994.

(e) A Reference Agent Agreement dated 28 November 1994.

(f) A Deed dated 28 November 1994.

14. According to the Listing Memorandum:

(a) The Notes will initially be represented by a temporary global note, without interest coupons, which will be deposited with a common depository for Company X, as operator of Company Y and Company Z on or about the closing date of 28 November 1994. The temporary global note will be exchangeable for definitive notes, with interest coupons attached, on or about 26 February 1995.

(b) Unless previously redeemed and cancelled, the Notes may at the election of eligible Noteholders be converted into participations in a transferrable loan facility to Company P in November 1999.

(c) The proceeds of the Notes, being US$1,735,000,000 less commissions and expenses incurred in connection with the issue and listing of the Notes, will be lent by Company P to Company I. Company I will use the proceeds to purchase the Port from Company H 'as part of a major regrouping exercise of the [Group's] business and operations, to meet projected capital expenditure requirements for the expansion of capacity of the [Port] and for general corporate purposes'.

(d) Various entities including Company AA have agreed with Company P to subscribe for the Notes at a price equal to 100 per cent of the aggregate principal amount of the Note. Company AA has also agreed to sell to Company S approximately US$1,148,000,000 in principal amount of the Notes subscribed by Company AA.

(e) [Company S's] holding of Notes will be used for the purpose of providing the long term external funding requirements of [the Group] and to that end it will consider from time to time the sale of Notes to meet [the Group's] future funding requirements arising from its proposed expansion into new port and port related projects'.

15. According to the Subscription Agreement, 28 entities as 'Manager' undertook in favour of Company P that each 'will subscribe and pay for the Notes on the Closing Date in the principal amount set out against its name' in the schedule annexed to that agreement. Company AA was one of the Managers. It agreed to subscribe and pay for Notes in the principal amount of US$1,208,000,000.

16. The Agreement Among Managers provided that Company AA shall maintain accounts ['the Subscription Accounts'] with Company Y and Company Z to which shall be credited all moneys payable by the Managers in respect of the Notes. The Agreement Among Managers further provided that payment for the Notes shall be made by the Managers on the closing date to the Subscription Accounts no later than 10 a.m. (Time of Country AB).

17. The Fiscal Agency Agreement provided that Company AA was appointed as fiscal agent, principal paying agent and conversion agent and that Bank AC in Country V was appointed as paying agent in connection with the issue of the Notes.

18. The Reference Agent Agreement provided that Company AA had agreed to act as the reference agent in relation to the Notes for the purpose of calculating and publishing the rate of interest from time to time applicable to the Notes and all matters incidental thereto.

19. The Deed provided that eligible noteholders would have an option to convert their notes into participation in a transferable loan to Company P.

The accounts

20. Company P's profit and loss accounts are found in its annual financial statements. In each relevant year it claims to have made a profit (chargeable to profits tax) from its borrowing and lending activity (being its sole activity) as follows:

Year	HK$
1994/95	1,036,416
1995/96	20,192,578
1996/97	10,083,249
1997/98	19,967,445
1998/99	20,000,414
1999/2000	20,077,908
2000/01	19,266,914

21. The above profits as claimed and calculated by Company P comprised the difference between interest receivable by Company P from Company I and the interest purportedly payable on the Notes together with any deposit interest earned and exchange gain or loss. The interest payable on the Notes as held by Company S is the subject matter of this appeal.

22. Company I has made a substantial profit from its operation of the Port. The amount of profit (chargeable to profits tax) for all years that are the subject matter of the assessments raised is as follows:

Year	HK$
1995/96	1,438,562,721
1996/97	2,422,776,308
1997/98	2,734,908,928
1998/99	2,435,427,181
1999/2000	2,626,916,252
2000/01	2,412,687,765

23. In computing and calculating its profits, a deduction was made by Company I for the interest purportedly payable to Company P, including that part of the interest proportional to and by reference to the interest payable for the Notes held by Company S. The said part of the interest purportedly payable is the subject matter of the related appeal by Company I in appeal No B/R 46/03.

24. Company S received interest income on the Notes and made some profits on the sale of the same and paid dividends to its shareholder. The interest income it derived from the Notes is the subject matter of a further related appeal by Company S in appeal No B/R 47/03. At the hearing before us, Mr Goldberg QC, Leading Counsel for the Respondent, indicated that the Revenue does not wish to maintain its assessments against Company S.

Chronology – prior to 28 November 1994

25. In order to appreciate the issues of this appeal, it is necessary to consider the issue of the Notes by Company P in a chronological context.

26. Company H was incorporated in Hong Kong on 28 June 1974. It commenced business as container terminal developers, owners and operators on 1 February 1975.

27. The Group was successful in its bids for the following container terminals in District U:

Year	Terminals
1974	Terminal XX
1975	Terminal WW
1985	Terminal YY
1988	Terminal ZZ
1991	Terminal UU East
1992	Terminal VV (2 berths)

(a) On 31 December 1975, Company AD acquired ownership of Terminal WW from the statutory receivers of the then operator Company AE for HK$25,000,000.

(b) By Conditions of Grant dated 17 February 1976, Lot No TT in District U was granted in favour of Company H at a premium of $19,500,000.

(c) On 28 October 1985, Company H entered into an agreement with Company AF, an affiliate of the Group AG and the operator of Terminals RR and SS at District U, that Company AD would assign its rights in Terminal WW to Company AF for HK$345,700,000 and that Company AF would support Company H's bid to acquire the entire rights for terminal YY.

(d) By an Agreement and Conditions of Grant dated 13 December 1985, Company AH was granted Lot No QQ in District U with an area of about 28.711 hectares at a premium of HK$110,000,000.

(e) By an Agreement and Conditions of Sale dated 20 April 1988, Company I acquired Lot No PP in District U with an area of about 31.5 hectares for HK$4,390,000,000. Terminal ZZ was completed in December 1991 with a total project cost of HK$6,834,000,000 inclusive of land premium.

(f) By an Agreement and Conditions of Grant dated 28 March 1991, Company AF and Company AI acquired Lot No OO in District U with an area of about 584,720 m^2 at a premium of HK$2,000,000,000. Company AI was established as a 50/50 joint venture between Company H and a PRC company, Company AJ. Company AI has two container berths and the total project cost for Company AI was HK$3,091,000,000.

(g) Discussions commenced in 1992 with the Government on the construction of Terminal VV on Island AK adjacent to District U. According to an article in Journal AL dated 23 July 1992, Government was asking for LegCo's endorsement on a HK$2,700,000,000 allocation for the Terminal VV project. The Government was expecting a HK$7,000,000,000 return from land grant in respect of that project. After protracted negotiations amongst the interested parties, the Hong Kong and the PRC governments, the matter was referred to the Sino-British Joint Liaison Group. The development of Terminal VV was discussed by the Sino-British Joint Liaison Group in November 1995. According to a newspaper report in Newspaper AM dated 2 November 1995, no consensus could be reached due to the alleged role of Company AN in that development. A grant of land over Terminal VV was finally signed on 7 December 1998 between the Government, Company H and two other joint developers with a total land premium of HK$343,400,000. Company H's share of the premium was HK$114,300,000.

(h) On 26 January 1994, the Container Handling Committee of the Port Development Board circulated amongst its members a brief report on the construction programme of Container Terminals MM and NN on Lantau. This report adopted, for planning purposes, May 1997 as the scheduled date for the opening of the first berth of Terminal MM.

28. In the early 1990's, the Company A group began to expand outside Hong Kong and investments were made in the following container terminals:

(a) Port of City AO in Country AP in 1991;

(b) River Ports in City AQ and City AR in the River Delta AS in Mainland in 1992;

(c) City AT deep-water port in City AU in Mainland in 1993 and

(d) City AV deep-water port in 1993.

29. The investment in City AT:

(a) City AT is about 45 kilometres away from District U. City AT is one of China's four international deep-water ports.

(b) According to Company A's annual report for 1993, a subsidiary of the Group entered into an agreement to take an effective 62% stake in a joint venture to develop, own, and operate the City AT port in the course of the year. The development was divided into two phases. Phase I envisaged the construction of two container and four general cargo berths scheduled for completion in the spring of 1994. Phase II involved the construction of three more container berths.

(c) The total estimated expenditure for Phase II was HK$4,400,000,000 with HK$1,300,000,000 reserved for land premium and HK$3,100,000,000 reserved for capital expenditure. Company H's share of such expenditure was estimated to be HK$3,800,000,000. The original anticipated completion date for Phase II was late 1996/early 1997. It was eventually completed in December 1999.

(d) As late as 1996 only Bank AW was prepared to advance HK$305,000,000 on this project.

(e) It is the case of Company P that an objective of the re-structuring considered on 2 September 1994 and referred to hereunder was to raise money for the PRC projects including City AT Phases I and II.

30. The River Ports

(a) The river ports are located in the River Delta AS. As opposed to the deep-water ports like District U and City AT which are highly capital intensive, river ports are labour intensive low infrastructure ports that act as feeders to the deep-water ports in Hong Kong and elsewhere.

(b) Company AX was formed in September 1994 to hold the ownership of the river ports in City AY, City AQ, City AR and City AZ. Further interests in the river ports of City BA and City BB were acquired in the years 1995 and 1997.

31. On 3 March 1994, Company P and Company I were incorporated in Hong Kong under the respective names of Company Q and Company R.

32. On 7 March 1994, Company S was incorporated in Country CA under the name of Company T.

33. Company BC wrote to Company H on 15 March 1994. Company BC referred to their understanding that Company H was contemplating a re-organisation of its operation and a transfer of the Port to a wholly-owned subsidiary with the wholly-owned subsidiary borrowing from a group finance company the necessary funds to finance the acquisition. Company BC outlined in that letter the terms whereby they would arrange the issuance of US$1,780,000,000 10 year fixed rate debentures to be listed on the Stock Exchange in Country V. One of the terms which Company BC proposed was that the wholly-owned subsidiary 'shall not declare and pay dividends more than 5% p.a. on its capital plus reserves until 30th June, 1999'.

34. By a valuation report dated 4 May 1994, Company BD provided Company H with a valuation of its property interests in the Port at HK$23,000,000,000.

35. Company P commenced business on 27 May 1994. It changed to its present name on 2 June 1994.

36. Company F was incorporated in Country CA under the name of Company G on 26 July 1994.

37. Company S changed to its present name on 4 August 1994.

38. By letter dated 31 August 1994, Bank AC sent to Company A the revised terms and conditions for a floating rate note issue in an amount which was the US$ equivalent of HK$13,400,000,000. Bank AC was prepared to form a syndicate which would fully underwrite the issue of the note with Bank AC underwriting up to the US$ equivalent of HK$1,050,000,000. Collateral undertakings were to be given by Company D including the condition that a member of the Group should subscribe for or purchase for its own account notes up to the US$ equivalent of HK$9,200,000,000 but that holder would not dispose of more than the US$ equivalent of HK$4,600,000,000 of notes without Bank AC's prior consent. Company D accepted these undertakings on 9 September 1994.

39. On 2 September 1994, a proposal was placed before the board of directors of Company H for its consideration. The proposal involved:

(a) The shareholders of Company H and Company AD transferring their shares in favour of Company F. Company H would become a wholly-owned

subsidiary of Company F and Company AD a wholly-owned subsidiary of Company H.

(b) Company H would sell the Port to its new Hong Kong wholly owned subsidiary Company BE, at fair market value of HK$23,000,000,000.

(c) Company H would incorporate a wholly owned subsidiary Company P to act as borrower for Company BE. Company P would issue debentures listed on the Stock Exchange in Country V to raise approximately HK$13,400,000,000 which it would lend to Company BE on an interest-bearing basis.

(d) Company BE would satisfy the HK$23,000,000,000 consideration due to Company H by:

(i) a net cash payment of HK$10,400,000,000;

(ii) an inter-group loan due to Company H of HK$6,500,000,000.

(iii) an interest free shareholder's loan of HK$6,100,000,000 from Company H to Company BE.

(e) Company BE would use the remainder of the borrowing at HK$3,000,000,000 to fund working capital and capital expenditure requirements. Prior to its use, this unexpended balance would be expended in bank deposits in Hong Kong.

40. The reasons for and the benefits derived from that proposal were identified as follows:

(a) Company H would have the required funds available for the following identified and future projects from the proceeds of sale of its assets to Company BE.

Project	**Total Investment**	**Estimated investment date – HK$ billion**				
		1994	**1995**	**1996**	**1997**	**1998 to 2002**
City AT port – PRC						
– Phases 1 & 2	3.8	1.6	0.7		0.7	0.8
– Phase 3	2.8					2.8

Terminal VV – HK	2.9	0.7	1.0	1.0	0.2	
Terminal MM – HK	3.4			0.8	1.2	1.4
City AR deep water port – PRC	0.8				0.2	0.6
Total	13.7	2.3	1.7	1.8	2.3	5.6

(b) RMB denominated loans were not available from lending sources to fund the above investments.

(c) Loan funding in significant amounts was available for Hong Kong located projects and/or operations.

(d) Given the then economic and political environment, Company BE was borrowing sufficient long term fund to pay Company H in full.

(e) To facilitate expansion into the PRC and other Asian countries with various joint venture partners, it was desirable to have separate corporate entities to hold the assets and operations to enable financing to be obtained on a project and country basis with separate credit risks.

(f) It was commercially desirable to separate Company H's activities as owner and operator of its significant Hong Kong port assets from its role as guarantor of its subsidiary and associated companies' performance and loans.

(g) A separate corporate entity would help to protect Company H from any legal proceedings and liens against its investment in other joint venture ports should a legal action succeed against Company BE as a port operator.

41. The Board of Company H held a meeting at 8:30 a.m. on 2 September 1994. According to the minutes of that meeting, Mr BF, Mrs BG, Mr BH, Mr BI and others attended that meeting. Mr BI informed the Board that the 31 August 1994 proposal from Bank AC 'were distributed to Directors'. Mr BF added that the floating rate note issue 'would raise long-term finance to match long-term nature of the port projects, and he believed that the [Bank AC] proposal was commercially attractive'. The Board resolved to approve the proposal as summarised in paragraph 39 above and an executive committee of four members was appointed to take all steps to effect that proposal. Mr BH and Mr BI were members of that executive committee.

42. By letter dated 5 October 1994, Company AA invited Company BJ and Bank BK to join in the issue of the Notes. By letters dated 24 October 1994 and 1 November 1994, Company BJ and Bank BK accepted the invitation.

43. By a written resolution dated 14 November 1994, the shareholder of Company F resolved that upon Company F receiving from Company H a dividend sum of HK$9,700,000,000, Company F, acting by any director, might advance an equivalent amount to Company S 'as an interest-free loan for the purposes of such sum being invested by [Company S] on behalf of [Company F] in time deposits, certificates of deposit, bonds, debentures or other investments to earn interest until such time as it may be required by [Company F]' and such director was authorised to execute a loan note for that purpose.

44. The Board of Company P held a meeting on 21 November 1994 approving the issue of the Notes and the documents relating to that issue. The Board of Company I held a meeting on the same day approving the guarantee of the Notes.

45. By a written resolution dated 22 November 1994, the sole shareholder of Company S considered the proposal that Company S would undertake treasury activities for Company F and its subsidiaries and resolved to invest Company S's cash funds in debentures or other loan instruments issued by Company F. At a Board meeting of Company S held in City BL on the same day, it was resolved that

(a) any director be authorised to execute a loan note in relation to an interest free loan of US$1,255,939,818.47 from Company F to Company S and

(b) Company S would subscribe for Notes to be issued by Company P in the amount of US$1,148,000,000.

(c) US$58,593,182.12 being the remaining balance of the proceeds received from Company F be invested in time deposits, certificates of deposits, bonds, debentures or other investments until the same be required.

46. The Listing Memorandum, the Subscription Agreement and the Agreement Among Managers referred to in paragraphs 13 to 16 above were all made on or dated 23 November 1994. By letter also dated 23 November 1994, Company AA confirmed with Company P that in consideration of Company AA acting as arranger and agent in connection with the issue of the Notes, an up-front fee of US$13,012,500 was payable under the Subscription Agreement and an agency fee of HK$250,000 was payable under the other related agreements.

47. By letter dated 24 November 1994, Company P gave Company AA the following instructions in relation to 'Transfer of Funds':

> ' For value 28th November 1994, please receive in full for our account with your Hong Kong Branch, account no. [ll] US$1,721,987,500.00 being net proceeds of our FRN issue from the account of [Company AA] in the name of [Bank AC – Hong Kong Branch], [Bank BM] account no. [kk] (CHIPS UID YYYYY).
> On receipt of these funds on same day value, please pay in full US$1,721,987,500.00 to [Company I's] account with [Bank AC – Hong Kong Branch] account no. [jj]

The sum of US$1,721,987,500 referred to in this letter was arrived at by deducting the up-front fee of US$13,012,500 referred to in paragraph 46 above from the total amount of the Note issue of US$1,735,000,000.

Company AA confirmed these instructions by signing on a copy of that letter.

48. By letter also dated 24 November 1994, Company H gave instructions to Bank AC – Country BT for the 'Transfer of Funds'. Bank AC – Country BT was instructed to receive US$1,345,833,493.97 from Company I for value on 28 November 1994. Upon receipt of these funds, Bank AC – Country BT was further instructed to remit:

(a) US$1,255,939,818.47 to Company F and

(b) US$139,240,311.85 to Company C.

49. On 25 November 1994:

(a) Company F changed its name to the present name and acquired all the shares in Company H.

(b) the Board of Directors of Company P passed a written resolution resolving to approve a loan note between Company P and Company I for a loan of US$1,721,987,500 from Company P to Company I with interest at 1% over LIBOR. As explained in paragraph 47 above, this sum of US$1,721,987,500 was the balance of the proceeds arising from the issuance of the Notes after deducting the up-front fee in favour of Company AA.

(c) According to a computer print out bearing the time 1617 and the date 25 November 1994, a message was sent to Bank AC – Country BT in relation to a customer transfer with transaction reference number OR32368. The transfer was for the sum of US$1,345,833,493.97 valued on 28 November 1994. Company I was the 'ordering customer' and Company H was the 'beneficiary customer'.

50. By a written resolution signed by all voting members of Company H and dated 26 November 1994, Company H resolved to sell the Port to Company I for HK$23,000,000,000. Company H further resolved to declare a dividend of HK$9,700,000,000 from the proceeds of sale. On the same day, Company H gave instructions to Bank AW to transfer HK$494,722,038.2 from its account to the account of Company C with Bank N.

Chronology of documentation dated 28 November 1994

51. In relation to the proceeds of the Note issue:

(a) By a credit advice dated 28 November 1994, Bank AC – Hong Kong Branch informed Company P of the crediting of US$1,721,987,500 into their account no ll. The sum of US$1,721,987,500 was arrived at as follows:

'[Company P] FRNs NEW ISSUE

Proceeds received from [Company S] ([Bank BM's] advice attached)	US$1,148,000,000.00
Proceeds received from other institutional investors	US$ 587,000,000.00
	US$1,735,000,000.00
LESS: deduction as arranged	US$ 13,012,500.00
NET AMOUNT	US$1,721,987,500.00

(b) The document ['the 0938 Advice'] attached to that credit advice was in these terms:

– Country BN –

– BANK BM INTRA DAY –

– US DOLLAR

ACCT: [kk] Bank AC – Hong Kong

–CREDITS– ON 11/28/94

1,148,000,000.00 s 5395000329FS FTS 0938 001182 R

YR REF: COVER TT/JH/MY
REC FR: Bank AC [Address] [Country BT] 0104
DESCR: COVER TT/JH/MY B/O Bank AC [Country BT] 0104
REMARK: /BNF/ATTN MS XXXX AT PHONE NO (yyy) yyy-yyyy

Company P FRN NEW ISSUE B/O Company S
RECGFP: 11280025.

(c) According to the statement of Company P's account ll with Bank AC – Hong Kong Branch, that account had a nil balance on 24 November 1994. On 28 November 1994, that account was first debited the sum of HK$1,721,987,500 and then credited with the like sum on the same day.

52. As between Company P and Company I:

(a) A loan note dated 28 November 1994 was signed between Company P and Company I. As opposed to the draft approved previously on 25 November 1994 and referred to in paragraph 49(b) above, this loan note was for an advance of US$1,735,000,000 (as opposed to US$1,721,987,500 under the loan note previously approved) from Company P to Company I with interest at 1% p.a. above LIBOR. Mr BH signed this loan note on behalf of both Company P and Company I.

(b) By a debit advice dated 28 November 1994, Bank AC – Hong Kong Branch informed Company P of the debit of US$1,721,987,500 from their account [ll] 'being fund transferred to [Company I's] USD savings account with us as per your instruction dated 28/11/94'. As pointed out in paragraph 51(c) above, the statement of Company P's account ll with Bank AC – Hong Kong Branch recorded a debit of HK$1,721,987,500 on 28 November 1994 followed by a credit of the like sum.

(c) By a credit advice dated 28 November 1994, Company I was informed by Bank AC – Hong Kong Branch of the credit of HK$1,721,987,500 into their account jj. According to the statement of Company I's account jj with Bank AC – Hong Kong Branch, that account had a nil balance on 24 November 1994. On 28 November 1994 that account was first debited with the sum of US$376,154,006.03 and the sum of US$1,345,833,493.97 before it was credited with the sum of US$1,721,987,500.

(d) The debit of US$376,154,006.03 was in respect of a fixed deposit which Company I placed with Bank AC – Hong Kong Branch for value on 28 November 1994 and maturing on 30 November 1994. It represented the difference between the credit of US$1,721,987,500 and the other debit of US$1,345,833,493.97 referred to in sub-paragraph (c) above.

53. As between Company I and Company H:

(a) They entered into the Port Purchase Agreement dated 28 November 1994 referred to in paragraph 9 above.

(b) By a debit advice dated 28 November 1994 Company I was informed of the debit of US$1,345,833,493.97 from their account jj. The same was said to have been remitted by telegraphic transfer to account no ii of Company H.

(c) By a credit advice dated 28 November 1994, Bank AC – Country BT Branch informed Company H of the credit of US$1,345,833,493.97 into their account no ii.

(d) There has been placed before us a 'remittance advice from [Bank BM] ['the 0944 Advice'] in these terms:

– Country BN –
– Bank BM INTRA DAY –
– US DOLLAR –

ACCT: [kk] Bank AC – HONG KONG

– DEBITS – ON 11/28/94

1,345,833,493.97 S 5162400329FS FTS 0944 R

YR REF: OR 32368
PD TO : Bank AC [Address] [Country BT] 0104
DESCR : OR32368 BNF/Bank AC – [Country BT]
REMARK: /BNF/ATTN.MS xxxx AT PHONE NO. (yyy) yyy-yyyy
RECGFP: 11280025

54. As between Company H and Company F:

(a) By a debit advice dated 28 November 1994, Company H was informed by Bank AC of the debiting of US$1,255,939,818.47 from their account [hh] in favour of Company F.

(b) By a credit advice dated 28 November 1994, Bank AC – Country BT Branch informed Company F of the credit of US$1,255,939,818.47 into their account ff. The amount was said to have come from Company H.

55. As between Company F and Company S:

(a) By a loan note dated 28 November 1994, Company F agreed to lend Company S US$1,255,939,818.47. The said loan 'shall not bear interest and shall be repayable forwith *(sic)* in one amount or in instalments ... upon the written demand or demands of [Company F] ...'. Mr BH signed this loan agreement on behalf of both Company F and Company S.

(b) By a debit advice dated 28 November 1994, Company F was informed by Bank AC – Country BT Branch of the debiting of US$1,255,939,818.47 from its account no ff. By a credit advice of the same date, Company S was informed by Bank AC – Country BT Branch of the crediting of US$1,255,939,818.47 into its account gg.

56. As between Company S and Company AA:

(a) By a debit advice dated 28 November 1994, Company S was informed by Bank AC – Country BT Branch of the debiting of US$1,148,000,000 from their account gg.

(b) In a letter dated 30 August 2004, Bank BO informed the Revenue that on 28 November 1994, US$1,148,000,000 came from Company S's account with Bank AC – Country BT Branch into Company AA's account '(as fiscal agent) in the name of [Bank AC – Hong Kong Branch] with [Bank BM]'. That amount was said to be 'Subscription amount paid by [Company S] (as a Manager) being its subscription of USD1,148 Million FRN'. By a further letter dated 20 October 2004 to the Revenue, Bank BO sought to correct a 'minor factual inaccuracy'. They pointed out that Company S was not a Manager and the Notes concerned were actually subscribed by Company AA under the Subscription Agreement.

Chronology after 28 November 1994

57. Company S disposed of Notes totalling US$214,000,000 in face value in the years 1995 and 1997. Such disposals arose from demands for repayment made by Company F. According to a resolution signed by all the directors of Company S dated 26 July 1995, the directors resolved to dispose of Notes with par value of US$4,000,000 as Company F had received capital call in respect of City AT.

58. By letter dated 19 January 1996, Company F confirmed its agreement with Company S to rescind the loan note of 28 November 1994 and to have the balance of the loan standing at US$1,061,707,830.04 regulated by the terms of that letter. Company S was given the right to repay the outstanding loan at any time. Company F further agreed to make available additional credit facilities on terms to be agreed. All facilities were to be interest free.

59. On 29 November 1996, Company I gave instructions to Bank AW. Bank AW was instructed to remit US$1,337,388.12 to Company P. This represented the interest differential between LIBOR + 100 basis point [the rate of interest for the loan between Company P and Company I] and LIBOR + 85 basis points [the rate of interest due under the Notes issued by Company P and held by Company S]. Bank AW was further instructed to remit US$57,730,927.85 to Bank AC – Hong Kong Branch. This sum represented the interest due under the US$1,735,000,000 Notes.

60. On 1 November 1999, 31 noteholders independent of the Group and the Company A Group exercised their rights to convert an aggregate amount of US$604,000,000 of the Notes into transferable loan. Company P repaid the sum of US$604,000,000 in 2000.

61. Between May and July 2001, Company S disposed of the remaining Notes with face value totalling US$934,000,000 to parties independent of the Group and the Company A Group.

62. By a written resolution signed by all the directors of Company I and dated 24 August 2001, Company I resolved to repay Company P its outstanding loan of US$1,131,000,000 by borrowing from Company C at an interest rate more favourable than LIBOR plus 1% payable to Company P.

63. On 28 November 2001, Company P redeemed all the outstanding Notes totalling US$1,131,000,000.

64. On 30 May 2003, the Commissioner issued her determination confirming additional profits tax assessments for the years of assessment 1994/95 to 1997/98 and 1999/2000 to 2000/01, and profits tax assessment for the year of assessment 1998/99, for Company P by disallowing the deduction of interest expense payable by it to Company S on the Notes. By notice of appeal dated 27 June 2003, Company P appealed against that determination.

Witnesses called on behalf of Company P

65. Mr BH, Mrs BG, Mr BF and Mr BP gave evidence before us.

66. Mr BH was the Deputy Managing Director of Company H between March 1992 and June 1996. He became its Managing Director in July 1996. He held that position until May 1998 when he left to work for Company BQ in Country AP. During his tenure with Company H, he also held directorships in Company I, Company D, Company P, Company F and Company S. Mr BH's testimony may be summarised as follows:

(a) The transfer of the Port from Company H to a wholly owned subsidiary was to enable the Group to realize significant inherent value and to bring in new funds

that could be used to finance the Group's plans to expand in Hong Kong and internationally. Without the transfer of the assets to a new company for the payment partially in cash the Group could not have created the pool of profits to be paid by way of dividend and used for expansion in the PRC and elsewhere.

(b) The original intention was to raise the full amount of US$1,735,000,000. This was the estimate of the then management of Company H as to the funding which the Group would require over the following eight years. He attended a meeting before August 1994 'where the [Bank AC] people made it clear to us they could handle this whole thing and sell the lot'. Due to the state of the then market conditions, the lead bank for the Note issue failed to deliver what they had originally indicated they could deliver. Company S was forced to take up a substantial part of the issue.

(c) He was responsible for the proposal that was placed before the Board of Company H on 2 September 1994. He accepted that the proposal sought to achieve the following objectives:

(i) To make Company H a subsidiary of Company F by value shifting arrangements.

(ii) To separate the operational activity of the group from its investment activity.

(iii) To separate the deep water ports from the river ports.

(iv) To separate the Hong Kong assets, operations and management from the China assets, operations and management.

(v) To raise finance so as to remove the difficulties of funding PRC projects and to meet the need for development capital in the group.

(d) There was no reference in the proposal to any dividend to be declared by Company H in favour of Company F nor to any advance by Company F to Company S. He did not regard the proposal misleading by virtue of such omissions. He said the shareholders and directors of Company H knew about the arrangement through meetings. They were told before 2 September 1994 as to what was going to happen on 28 November 1994.

(e) Tax was not a matter discussed at the 2 September 1994 meeting. He himself did not take any tax advice. There were lawyers and accountants in-house and

he left it to them to look at the taxation issue. He himself did not come up with the idea of the dividend. It was the suggestion of the accounting team and the lawyers in-house. He said there was no point in leaving the dividend in Company H and they needed cash in Company S.

(f) A signing ceremony was held on 23 November 1994. The subscription agreement was signed that day. On 28 November 1994, the people involved were all in one room signing documents and giving instructions for the movement of funds. Everything happened all at once. He expected some sort of master plan for those two days but he left that to the accountants and the lawyers. He himself signed some documents in City BL in the morning of the 28. He returned to Hong Kong and signed the loan note between Company P and Company I. His involvement on the 28 was restricted to that.

(g) What happened on 28 November 1994 happened in the following order with money moving from:

(i) Company AA to Company P;

(ii) Company P to Company I;

(iii) Company I to Company H;

(iv) Company H to Company F;

(v) Company F to Company S and

(vi) Company S to Company AA.

(h) It was put to Mr BH that according to the 0938 Advice, US$1,148,000,000 came at 0938 from Bank AC – Country BT into Bank AC – Hong Kong's account with Bank BM and according to the 0944 Advice US$1,345,933,493.97 came out of the said account of Bank AC – Hong Kong with Bank BM and returned at 0944 to Bank AC – Country BT. Mr BH did not refute Mr Goldberg QC's suggestion that the money did not come to Hong Kong nor did he challenge Mr Goldberg QC's further suggestion that Company S paid US$1,148,000,000 to Company AA before receiving any payment from Company F when Company S itself did not have any money to fund that payment. Mr BH explained that he was not a party to the banking arrangements and 'as far as how the bank handled the money as between [Company S] and [Company P], that was their problem'.

(i) Mr BH emphasised that after the re-structuring, his group ended up with cash and cash equivalent. Part of the cash generated was used to pay for the purchase of City AT. The balance of the cash generated was placed on deposits. The US$1,148,000,000 Notes held by Company S could be sold in the market and converted into cash. 'So we had the funds effectively for us to meet our capital expenditure programme'. He disagreed with the suggestion of Mr Goldberg QC that in 1994 his group took as much cash as the market could sustain at the time. He reckoned that his group only took as much as Bank AC could arrange.

67. Mrs BG is a qualified solicitor. She joined Company A as an Executive Director on 11 October 1993. She was appointed deputy Group Managing Director of Company A on 1 January 1998. According to Mrs BG:

(a) The restructuring was designed to separate assets located in Hong Kong from assets located in the PRC and to raise funds on the strength of the former. There was a very real need for substantial funding for the Group. The amount of investment planned was HK$13,700,000,000. As Company A had expansion plans in its other business, it did not want to use funds on hand or being generated from other business to invest in ports.

(b) The structure of the Note issue from the outset had been that no Group company would be required to subscribe or take up the Note. This did not materialise as the market forces moved against them and the issue lost its appeal as a 'hot' issue.

(c) Bond issues have an advantage over syndicated loans in that they provide access to a wider universe of lenders. It is common-probably invariable – practice to use newly incorporated special purpose companies to issue bonds.

(d) As with other major proposals, the Company A or the Group undertook serious review of the proposal including going through legal, finance, tax and company secretarial departments of the groups. Whilst the restructuring was constituted so as not to result in adverse tax consequences, the primary aim was to achieve the commercial objectives.

(e) Each of the companies involved in the re-structuring served a specific role:

(i) Company P served the business purpose of raising finance. It made taxable profits in Hong Kong.

(ii) Company I served the business purpose of having as its sole activity the ownership and operation of the valuable Port.

(iii) Company S is a treasury company which operates the central cash management for the ports group of companies. Company S could have been set up in Hong Kong rather than in Country CA but that would not have meant that the interest earned by it would have been taxable in Hong Kong as the provision of credit in relation to the Notes was outside Hong Kong.

(f) The payment of dividends by Company H to Company F and the advance by Company F to Company S were key elements in the re-structuring proposal. She was cross examined on whether these were put to the board of directors of Company H:

Q.	It follows from that, does it not, that a proposal which puts funds into [Company H] and does not take them out is a proposal that the board can accept and implement?
A.	Because there were other board meetings and other discussion as well. There was a board meeting for the declaration of the dividend.
Q.	On 2 September, what they agreed to was a proposal that [Company H] would keep the money?
A.	[Company H] would raise the money.
Q.	[Company H] would keep the money, that is what it says on page 43: '[Company H] will have a portion of the required funds ...'
A.	It will have it available.
Q.	At the same time as this was going on, was it intended that [Company H] was going to pay a dividend or did that come about afterwards?
A.	At that particular moment. I do not know.

(g) The benefit of moving the cash from Company H to Company F is 'Because we wanted to identify this as cash which is surplus to [Company H]'.

(h) She did not have discussions with the bank to arrange what was happening on 28 November 1994. '... the people [in the Company] would have done it'. She has no knowledge on what the arrangements with the bank were and she could not assist on the cashflow that day.

(i) The Port was transferred from Company H to Company I. She could not however identify any document evidencing the completion pursuant to the Port Purchase Agreement. She could not identify any demand under clause 3(a) of that agreement for that part of the consideration of HK$10,394,275,824. She assumed that the same must have been paid but failed to draw our attention to the manner and mode where such payment was made.

(j) Company S did not subscribe for the Notes but bought the same from Company AA. She accepted that Company S did not have any money to subscribe.

(k) Company S disposed of part of its portfolio in 1995, 1997 and 2001 raising in total US$1,148,000,000. Company S had no difficulty in selling the Notes in 1995. Company S used the proceeds of sale to repay the loan that was then outstanding between Company S and Company F. Company F would advance the money into the operations where money was required. Such advance was interest free.

(l) Subsequent sales by Company S were not as easy as had initially been contemplated because the projected expenditure requirements for Terminals VV and MM did not materialize as early as anticipated and in addition, alternative, cheaper funding sources became available for City AT.

(m) On 23 May 2000, Company I arranged a HK$5,000,000,000 syndicated bank loan with 18 banks and used HK$4,700,000,000 of the proceeds to repay Company P. Company P used the funds received from Company I to repay the transferable loans.

68. Mr BF is the Group Managing Director of Company A. He held that position since 1 September 1993. According to Mr BF:

(a) He first became aware of the proposal to restructure the Group in mid 1993. The need to raise funds was one of the most significant issues at the time. There was no question at that stage of any part of the funding being provided internally or held by a member of the Group.

(b) The essence of the proposal on which he was briefed was in substance that which was ultimately implemented save for the fact that the whole of the required funding was to be raised from outside financial institutions.

(c) What the Board of Company H approved on 2 September 1994 was the proposal as set forth in the memorandum tabled before that meeting.

(d) He left the details to Mrs BG and Mr BI. He is not in a position to assist the Board on such details.

69. Mr BP is the Managing Director and the Head of Asia Pacific Investment Banking Group of Company BS. Prior to joining Company BS, Mr BP held executive positions with various banks in Hong Kong. According to Mr BP:

(a) During the early 1990s, obtaining financing by Hong Kong companies for projects in the PRC was relatively difficult. Obtaining financing in the PRC from domestic banks was even more difficult.

(b) The reasons given to the Board of Company H on 2 September 1994 in support of the re-structuring were basically sound.

(c) It was (and remains) the usual practice for such note issues to use a special purpose vehicle and for the issue to be guaranteed by the operational company within the group.

(d) His written statement was prepared on the basis of specific questions posed to him and he was not asked to comment on the movement of fund beyond the stage of Company H.

(e) The pricing for the 1994 note issue was tight. It was quite an achievement for Bank AC to sell US$587,000,000 of that issue. Had the bank that he is working for been in charge of the issue, he would not have recommended his bank to proceed with an issue when only US$500 odd million out of US$1.7 billion could be sold.

Discussion on the evidence adduced on behalf of Company P

70. Mr Goldberg QC attacked the case of Company P on the basis that a large number of documents which one would normally expect from deals of this nature did not form part of Company P's presentation. We believe the problem is more fundamental. Four important aspects of this appeal received little or inadequate treatment in the evidence.

(a) First, the initial intention was to raise externally the totality of the funds required. The 31 August 1994 letter from Bank AC made it clear that a member of the Group had to purchase up to US$ equivalent of HK$9,200,000,000 of a HK$13,400,000,000 issue. The initial intention was clearly frustrated. We would have expected discussions being held to consider this issue and the factors for pressing ahead being debated extensively. No such evidence has been placed before us.

(b) Secondly, a member of the Group was committed to take up Notes in an aggregate amount up to US$ equivalent of HK$9,200,000,000. Where would that money come from? It was not a problem of Company AA or Bank AC. It was a problem of the Group. We do not regard this as a matter of details. The raising of this amount must have received the attention of the senior management. Had this issue been delegated to a subordinate, the senior management must have been fully briefed on the solution offered. It is not a proper discharge of the onus of proof to take shelter behind the delegation and offer no evidence on the nature, the planning and the execution of the solution.

(c) Thirdly, the declaration of dividend by Company H and the loan from Company F to Company S were not considered at the Board meeting of Company H on 2 September 1994. The author of these steps had not been identified. There is no direct evidence on the considerations that prompted the author to devise these steps as part of the re-structuring.

(d) Fourthly, none of the witness called could assist this Board on the flow of fund on 28 November 1994. The onus rests on Company P. No witness from either Bank AC or Company AA was called. We are not persuaded that Bank AC or Company AA could not assist by virtue of change of personnel. For an issue of this magnitude, we would have expected detailed records being kept on the discussions between the parties. Bank BO expressed no difficulty in responding to the inquiries from the Revenue in their letters dated 30 August 2004 and 20 October 2004. Mr BP's evidence is of limited assistance. He was not asked to express any view on the fund flow which is a crucial issue in this appeal.

(e) We do not accept that Company P was in any way taken by surprise in relation to any of these issues. As long ago as 15 January 1997, the Revenue was pressing for information on 'the sources from which the member company derived funds for acquiring the loan notes' and 'how the funds for loan notes acquisition were remitted to [Country V]'.

71. The evidence before us indicates clearly the existence of two paper trails as depicted in a chart submitted by Mr Goldberg QC and annexed hereto as Appendix III. The first paper trail consists of the 0938 Advice and the 0944 Advice. US$1,148,000,000 first arrived in City AB from Country BT at 0938 as a payment from Company S to Company AA. It returned to Country BT from City AB six minutes later as a payment by Company I to Company H. No part of that was ever remitted to Hong Kong. The second paper trail consists of the various credit and debit notes and bank statements. They show that money had allegedly moved from Company AA to Company P; from Company P to Company I; from Company I to Company H; from Company H to Company F; from Company F to Company S and from Company S to Company AA. Company S had allegedly paid money to Bank AC at 0938 when it did not have the money to do so at that juncture. We accept the submission of Mr Goldberg QC that no real money was involved in this second paper trail. All that happened is that on an unknown date Company S instructed its bank to pay US$1,148,000,000 to Company AA for value on 28 November 1994. That instruction amounted no more than a promise to pay ['the Promise'] albeit all parties concerned treated the Promise as money of an amount of US$1,148,000,000. On 28 November 1994:

(a) Company AA treated itself as receiving the Promise;

(b) Company AA transferred the Promise to Company P and in return Company AA received Notes with a face value of US$1,148,000,000;

(c) Company AA transferred the Company S Notes to Company S in satisfaction of its obligation to do so.

(d) Company P transferred the Promise to Company I and, in return, Company I acknowledged its indebtedness to Company P in the sum of US$1,148,000,000;

(e) Company I transferred the Promise to Company H and Company H treated itself as having been paid the US$1,148,000,000 due to it on sale of the Port;

(f) Company H declared a dividend in favour of Company F. Part of the dividends was satisfied by the transfer of the Promise.

(g) Company F treated itself as receiving the dividends in full and on lent the same including the Promise to Company S.

Company S did not actually have money to pay Company AA until Company AA had paid Company P and money had passed around in a circle. At no time did Company AA put any money into that circle. The Promise was all passed between Company AA, Company P, Company I, Company H, Company F and Company S. The Promise was cancelled out when the same eventually

reverted back to Company S as the original promisor. The issue of the Company S Notes did not actually produce any money for Company H's business.

72. The only real money raised was the sum of US$587,000,000 in respect of Notes subscribed by the independent financial institutions:

(a) After deducting the up-front fee of US$13,012,500 from US$587,000,000, the balance of the real money was US$573,987,500.

(b) The difference between the amount of US$1,345,833,493.97 which returned to Country BT as evidenced by the 0944 Advice and the amount of US$1,148,000,000 which left Country BT six minutes earlier as evidenced by the 0938 Advice was US$197,833,493.97. That sum never left Country BT for Hong Kong. US$107,939,818.47 was transferred to Company S to be held as spare cash. US$89,893,675.50 formed part of the transfer to Company C to pay for the investment in City AT.

(c) The balance of the hard cash raised amounting to US$376,154,006.03 was placed on fixed deposit in the name of Company I with Bank AC – Hong Kong; as referred to in paragraph 52(d) above.

The principal issues

73. The debate before us centred around two principal areas:

(a) The applicability of sections 61 and 61A of the Inland Revenue Ordinance ['IRO'].

(b) The applicability of the Ramsay principle in the context of section 16 of the IRO.

Section 61A of the IRO

74. The section applies where three conditions are satisfied:

(a) There has been a transaction that has been entered into or effected after the commencement of the Inland Revenue (Amendment) Ordinance 1986.

(b) The transaction has, or would have had but for section 61A, the effect of conferring a tax benefit on a person referred to in that section as 'the relevant person'.

(c) Having regard to seven factors referred to in that section, it would be concluded that the transaction was carried out for the sole or dominant purpose of enabling the relevant person to obtain a tax benefit.

75. The transaction:

(a) Willoughby & Halkyard's Encyclopaedia of Hong Kong Taxation Vol 4 pointed out at [18815] that 'In applying section 61A the Commissioner, and any Board of Review or court, must be scrupulous in identifying the "transaction" to which the various criteria in section 61A(1) are tested'.

(b) Prior to the hearing of this appeal, Company P applied to the Board for directions to compel provision of particulars by the Revenue as requested in Company P's letter dated 5 August 2003. For reasons given by the Board in its decision dated 14 May 2004, the Board declined to give the directions sought. In the course of submissions before that Board, then Counsel for the Revenue made it clear that the transaction relied upon was the following 10 steps referred to in paragraph 3(4) of the Commissioner's determination:

(i) Company P was incorporated in Hong Kong on 3 March 1994.

(ii) Company I was incorporated in Hong Kong on 3 March 1994.

(iii) Company S was incorporated in Country CA on 7 March 1994.

(iv) Company F was incorporated in Country CA on 26 July 1994 to hold 100% equity in Company H.

(v) Company H sold its business assets to Company I at a price of HK$23,000,000,000 and considered that it had made an exceptional profit of HK$14,150,000,000 available for dividend.

(vi) Company H declared dividends to Company F.

(vii) Company F made interest free loans to Company S.

(viii) Company P issued US$1,735,000,000 Notes listed on the Country V Stock Exchange and lent the proceeds to Company I.

The transaction so identified had been referred to in the course of submissions as 'the Wide Transaction'.

(c) In the written opening submission of the Revenue dated 23 October 2004, the Revenue identified the following steps as constituting the transaction:

(i) The payment of dividends by Company H, out of the distributable reserves created by the preliminary step, to its immediate parent, Company F, a Country CA company.

(ii) The making of an interest free loan by Company F, using the moneys paid to it at Step (i), to its sister subsidiary, Company S, another Country CA company.

(iii) The payment by Company S, using the money lent to it at Step (ii), of US$1,148,000,000 to Company AA, paid as the purchase price of loan notes ('the Company S Notes') to be issued by Company P. Company P is a Hong Kong company, a sister subsidiary of Company I and a member of the Group.

(iv) The payment by Company AA of US$1,148,000,000 to Company P for the issue of the Company S Notes by Company P, and the transfer, pursuant to a pre-existing agreement, of those loan notes to Company S. At the same time as issuing the Company S Notes, Company P issued another US$587,000,000 of loan notes to third parties and has used that amount of money in its business.

(v) The loan of US$1,148,000,000, using the moneys paid to Company P at step (iv), by Company P to Company I, its sister subsidiary.

(vi) The payment by Company I of US$1,148,000,000 to Company H, apparently as part of the purchase price due to Company H, using the moneys paid to Company I at step (v), to fund the payment of the dividends paid to Company F at step (i), so closing the circle.

(vii) Company S obtained interest free loans from Company F to acquire US$1,148,000,000 Notes, equivalent to 66.1% of the whole issue.

(viii) Company I paid Company H for the business assets.

The transaction so identified had been referred to in the course of submission as 'The Narrower Transaction'. Having regard to the degree of difference between the Wide Transaction and the Narrower Transaction; the fact that Mr Goldberg QC's written submission was circulated amongst the parties on 23

October 2004; the fact that no significant prejudice had been demonstrated to us in relation to the position of the appellant and the early stage of the proceedings, we indicated in the course of Mr Gardiner QC's opening for Company P in the third day of hearing that he should tackle the Narrower Transaction so formulated by Mr Goldberg QC.

(d) On the basis of The Commissioner of Taxation of the Commonwealth of Australia v Peabody [1994] 181 CLR 359 Mr Goldberg QC submitted on the first day of hearing that the Revenue could, right up to the Court of Final Appeal, identify a transaction so long as the Revenue is not being unfair to the taxpayer. He indicated he may identify an even narrower transaction in the course of the hearing before us. At the invitation of this Board on the third day of hearing, Mr Goldberg QC identified the Narrowest Transaction as constituted by Company P's alleged borrowing on the basis of the Company S Notes. Mr Gardiner QC submitted that a transaction within section 61A must be capable of standing on its own. The borrowing by Company P on the basis of the Company S Notes was part of a total issue of US$1,735,000,000 and it could not stand on its own without the on-lending and the guarantee by Company I. Section 61A(3) defines 'transaction' to include 'a transaction, operation or scheme whether or not such transaction, operation or scheme is enforceable, or intended to be enforceable, by legal proceedings'. We see no reason why the borrowing, the on-lending and the guarantee cannot be regarded as three separate transactions. Whilst the issue was for a total of US$1,735,000,000, each of the Managers and Company S (if Company S did so subscribe) entered into a separate transaction with Company P in relation to that portion of the issue that each had undertaken to subscribe.

76. Tax benefit:

(a) 'Tax benefit' is defined by section 61A(3) to mean 'the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof'.

(b) Mr Gardiner QC submitted that one needs to find a liability, present or future, that Company P has avoided as the 'liability to pay tax' predicates that there could have been a liability past or future to which Company P could have been subjected but which has been avoided (postponed or reduced) by entering into the identified transaction. Mr Gardiner QC cited the Judgment of Lord Donovan in Mangin v Inland Revenue Commissioner [1971] AC 739 at 748E in support of his proposition. Lord Donovan's pronouncement was in the context of section 108 of the New Zealand Land and Income Act 1954. The wordings of that section (see page 748A) are different from the wordings of section 61A. Unless local jurisprudence is totally silent on this issue, we are

reluctant to place weight on other Commonwealth authorities on different fiscal provisions. On this issue, the Court of Appeal had considered analogous arguments in Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773. By paragraphs 47 and 48 of its Judgment, the Court of Appeal (at page 791) rejected this argument in these terms:

'Ground 2b alleges that the Judge erred in determining that there was a tax benefit when the definition of tax benefit in s. 61A(3) predicates that there must either be (i) some pre-existing liability to tax which is being avoided, or (ii) some pre-existing circumstances which would give rise to, or might be expected to give rise to, a liability to pay tax, when neither of such circumstances was present.

The argued "pre-existing" liability to tax or circumstances do not appear in s. 61A(3) or anywhere else in the Ordinance having any bearing on the meaning of the 'transaction' referred to in that section. We do not think it is necessary to deal with this ground except to say that it has no substance whatsoever'.

We are bound by Cheung Wah Keung and we reject this submission of Mr Gardiner QC.

(c) Mr Goldberg QC relied on the words 'or the reduction in the amount thereof' and submitted that those words mean the reduction in the amount of tax as opposed to the reduction in the amount of the liability to pay tax. We agree with this submission. Both naturally and grammatically it violates the language of that definition to construe it to mean 'reduction in the amount [of the liability to pay tax]'.

(d) We are of the view that each of the transactions as referred to in paragraph 75(b) to (d) above has, or would have had but for section 61A, the effect of conferring a tax benefit on Company P. The tax benefit consisted of the reduction in the amount of tax by ostensible payment by Company P of interest on the Company S Notes.

77. Sole or dominant purpose to obtain a tax benefit

(a) As explained by Rogers JA in Yick Fung Estates Ltd v Commissioner of Inland Revenue [2000] 1 HKLRD 381 at 399:

(i) The tests set out in section 61A have to be applied objectively.

(ii) The matters set out in subsections (a) to (g) must be considered and the strength or otherwise of the various resulting conclusions from considering those matters must be looked at globally. On the basis of that assessment, it must be decided whether the sole or dominant purpose was the obtaining of a tax benefit.

(b) The manner in which the transaction was entered into or carried out:

(i) We find that the transaction was entered into and carried out as part of pre-conceived plan in a circular manner. We are not persuaded that there was any commercial justification for the declaration of dividend by Company H in favour of Company F and the loan by Company F to Company S. It is said that Company S was discharging treasury functions for the group. We fail to see any genuine benefits to the group by designating such functions to Company S.

(ii) Company P says that the transaction gave funding and the source of funding that the Group required to fund its expenditure requirements. The transaction did not fulfill such grand purpose. The amount of investment planned was HK$13,700,000,000. The initial intention was to raise the entirety of the US$ equivalent of HK$13,400,000,000 from the market. This intention was frustrated and a member of the Group had to subscribe up to US$ equivalent of HK$9,200,000,000. This amounted to about 68% of the entire issue. According to Mr BP, he would not have proceeded with the issue in those circumstances.

(c) The form and substance of the transaction

(i) Company P argued that bonds are common instruments for raising funds for commercial organizations. The Group had a real need for funds. The transaction that they ended up with was inferior but they ended up with liquid cash resources and realisable cash resources to fund their expenditure.

(ii) We find that the form of the transaction is the facade of raising of US$1,148,000,000 as part of a US$1,735,000,000 note issue by Company P. The maintenance of such facade would have facilitated the deduction of interest resulting in consequential reduction of tax when in substance no money at all was raised on 28 November 1994 on the basis of the Company S Notes. We further find that the issuance of the Company S Notes was wholly distinct from the re-structuring. We are

not persuaded that the re-structuring could not have proceeded without such issuance.

(iii) Whilst Mr BH drew a distinction between what Bank AC as opposed to others could achieve, Mr BP took the view that the pricing of the Notes was tight and Mrs BG accepted that the market turned against them in 1994. We are inclined to the view that the Notes had not been well received in the market in 1994. Bank AC made it a condition that the holder of the Company S Notes would not dispose of more than the US$ equivalent of HK$4,600,000,000 without their prior consent. Looking at the matter objectively, given the dim outlook of the Notes in 1994 and comparing the massive fiscal advantage resulting from the exercise, we are driven to conclude that fiscal considerations overtop the commercial benefits of having in hand the Company S Notes as an uncertain means of raising funds.

(d) The result in relation to the operation of the IRO that, but for section 61A, would have been achieved by the transaction:

(i) Company P submitted that, but for section 61A, the result that would have been achieved by the transaction was the production of Company P's profit through its borrowing from Company S and advancing to Company I.

(ii) We disagree. No real money at all was or could be raised by the Group on 28 November 1994 via the Company S Notes. But for section 61A, the result achieved in relation to the IRO would be that Company P would obtain a deduction for interest which it paid on a borrowing which has no substance.

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

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

(i) Company P submitted that the financial positions of a number of companies in the Group were altered as a result of the restructuring in November 1994: Company I acquired a valuable business, Company H swapped assets for shares in a subsidiary and cash, Company F received a dividend and Company S received an interest free loan from

another company within the same group. Company P further submitted that these changes occurred but they were all real changes driven by manifest commercial considerations and not for the purpose of obtaining a tax benefit.

(ii) We are unable to accept that submission. Company P had undertaken liabilities in respect of the Company S Notes although in substance it did not raise any money by their issue. Company H was impoverished and assets were moved from Hong Kong.

(g) Whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm's length under a transaction of the kind in question:

(i) Company P submitted that all the lendings were at market rate. The only exception was the loan from Company F to Company S which would not have made any difference.

(ii) We are of the view that this submission ignored the fact that Company P had undertaken an obligation in respect of the Company S Notes without in substance receiving any money for their issue. Such obligation would not normally be created between persons dealing with each other at arm's length.

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

(i) Company P submitted on the basis of Commissioner of Inland Revenue v Hang Seng Bank Ltd [1991] 1 AC 306 the interest payable on the Company S Notes is not from a source in Hong Kong and is accordingly not subject to Hong Kong profits tax. Company P further submitted that it would have made no difference if Company S, instead of being established in Country CA, had been established in Hong Kong.

(ii) We accept this submission of Company P.

(i) Looking at the matter globally, we have no hesitation but to conclude that all the persons involved entered into or carried out the transaction for the dominant purpose of enabling Company P to obtain a tax benefit. A facade was created so as to enable Company P to seek a deduction, in computing Hong Kong taxable profits, for interest supposedly payable on the Company S

Notes and in the process removing value from Hong Kong free of Hong Kong tax.

78. On the basis of section 61A(2), the Assistant Commissioner shall assess the liability to tax of Company P as if the transaction or any part thereof had not been entered into or in such other manner as the Assistant Commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained. Section 68(8)(a) of the IRO further provides that *'After hearing the appeal, the Board shall confirm, reduce, increase or annul the assessment appealed against or may remit the case to the Commissioner with the opinion of the Board thereon'*. In order to counteract the tax benefit, we are of the view that all the interest paid on the Company S Notes should be disallowed. We hereby increase the assessment to the figures as outlined in the letter from the Department of Justice to the solicitors of Company P dated 26 November 2004.

Section 61

79. Mr Goldberg QC submitted that

(a) Section 61 refers to *'any transaction which reduces or would reduce the amount of tax'*.

(b) Company P entered into two transactions: Company P borrowed from Company AA or Company S and it lent to Company I.

(c) Section 61 has nothing to do with the lending as it does not reduce tax. The borrowing however creates outflows and, if respected, would reduce the amount of tax payable by Company P.

(d) The issue therefore is whether the borrowing is artificial or fictitious.

(e) Such borrowing is artificial or fictitious as Company P has not in substance borrowed money under the Company S Notes.

80. Mr Gardiner QC submitted that

(a) Company P could not have lent US$1,735,000,000 unless it had the funds to do so and Company P could only have had the funds to do so by borrowing under the Note issue as it did.

(b) There is no justification for the Commissioner to divide the borrowing on the Notes into an alleged fictitious portion of US$1,148,000,000 and the remaining balance. He relied on the fact that for the first 90 days the issue was evidenced as a global loan note for the totality of the issue.

81. In Cheung Wah Keung (above cited), the Court of Appeal (at 788H) adopted the meaning of 'artificial or fictitious' as explained in the judgment of Lord Diplock in Seramco Superannuation Fund Trustees v Income Tax Commissioners [1977] AC 287 at page 298

> *' "Artificial" is an adjective which is in general use in the English language. It is not a term of legal art; it is capable of bearing a variety of meanings according to the context in which it is used. In common with all three members of the Court of Appeal their Lordships reject the trustees' first contention that its use by the draftsman of the subsection is pleonastic; that is, a mere synonym for "fictitious". Fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. "Artificial" as descriptive of a transaction is, in their Lordships' view a word of wider import. Where in a provision of a statute an ordinary English word is used, it is neither necessary nor wise for a court of construction to attempt to lay down in substitution for it, some paraphrase which would be of general application to all cases arising under the provision to be construed. Judicial exegesis should be confined to what is necessary for the decision of the particular case.'*

The Court of Appeal further pointed out in Cheung Wah Keung (at page 789D) that commercial realism or otherwise can be one of the consideration for deciding artificiality.

82. The letter from Bank AC to Company A dated 31 August 1994 made it clear that 'A member of [the Group] shall subscribe for or purchase for their own account ... up to US$ equivalent of HK$9,200 Million ...'. The subscription at US$1,148,000,000 was eventually taken up by Company S. Whilst such subscription or purchase by Company S was part of the global issue, it did not lose it separate character as a stand alone transaction. The Credit Advice dated 28 November 1994 treated the proceeds from Company S as separate and distinct from the proceeds from other institutional investors. The global note was merely a temporary measure. It was in bearer form and without interest coupons. The same was to be deposited with a common depository. Upon such deposit, Company Y and Company Z was to credit each subscriber for Notes with a principal amount of the temporary global note equal to the principal amount thereof for which it has subscribed and paid. The temporary global note was exchangeable for definitive Notes with interest coupons on or about 26 February 1995. We have no difficulty in identifying the Company S Notes as separate and distinct from the remaining Notes.

83. We are of the view that there never was a borrowing of US$1,148,000,000 on the basis of the Company S Notes. No real money ever changed hands. The Company S Notes are both artificial and fictitious.

84. On the basis of section 61, the assessor may disregard the Company S Notes and assess Company P by allowing all the purported interest payable on the Company S Notes for all periods they were in issue.

The Ramsay principle and section 16 of the IRO

85. The classic statement of the *Ramsay* principle is to be found in the speech of Lord Brightman in Furniss v Dawson [1984] AC 474 at page 527 where his Lordship said:

> '*First, there must be a pre-ordained series of transactions, or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end ... Secondly, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax. If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied.*'

86. The *Ramsay* principle was extensively considered by the Court of Final Appeal in Shui Wing Ltd v Commissioner of Estate Duty (2000) 3 HKCFAR 215 and Collector of Stamp Revenue v Arrowtown Assets Ltd (2003) 6 HKCFAR 517. In the Shui Wing case, Sir Anthony Mason explained at page 239 that:

> '*The principle, according to the House of Lords, is both a rule of statutory construction applicable to revenue statutes and an approach to the analysis of the facts. At first instance, Findlay J. had difficulty in seeing the principle as a rule of construction. His Lordship considered that it was in truth a way of viewing or, as I would express it, a way of analysing the facts. This element of the Ramsay principle may be expressed by saying that where there is a single pre-ordained, composite transaction intended to be carried out in its entirety, the court is not compelled for tax purposes to ignore its composite character and to break it up into its individual constituent steps so that the statute is then applied to those individual steps separately. If the purpose of intermediate steps in the composite transaction was fiscal they may be disregarded. The composite transaction may then have consequences which bring it within a charging provision of the statute*'.

87. In the Arrowtown case, Ribeiro PJ (At 533G) succinctly summarised the position as follows:

> '*... I am of the view that Lord Brightman's formulation is not a principle of construction, but, as stated above, a decision that the Court is entitled, for*

> *fiscal purposes, to disregard intermediate steps as having no commercial purpose as a consequence of an orthodox exercise of purposive statutory construction'.*

88. Our attention was drawn to judgments of the House of Lords in Barclays Mercantile Business Finance Ltd v Mawson (Her Majesty's Inspector of Taxes) [2004] UKHL 51 and Her Majesty's Commissioner of Inland Revenue v Scottish Provident Institution [2004] UKHL 52 which were delivered after conclusion of the hearing before us. Ribeiro PJ's statement of principle in Arrowtown quoted in paragraph 86 above was expressly approved in Barclays Mercantile Business Finance Ltd v Mawson (Her Majesty's Inspector of Taxes).

89. Mr Goldberg QC expressly disavowed reliance on any doctrine of fiscal nullity on the basis of these authorities. He submitted that on the basis of Shui Wing Ltd and Arrowtown, our duty is to thoroughly and properly examine the facts so as to ascertain the true nature of what had happened. We should adopt a purposive construction of section 16 in the light of our realistic assessments of the facts. We accept that submission.

90. Section 16 is not a relieving provision. It permits deduction of expenses 'to the extent to which they are incurred ... in the production of profits'. No real money was raised by the Company S Notes. As there was no capital sum, no interest was payable. The 'interest' was not incurred in the production of profit. The 'interest' was merely part of a facade to achieve a tax deduction. The deduction sought is clearly not within the ambit of section 16.

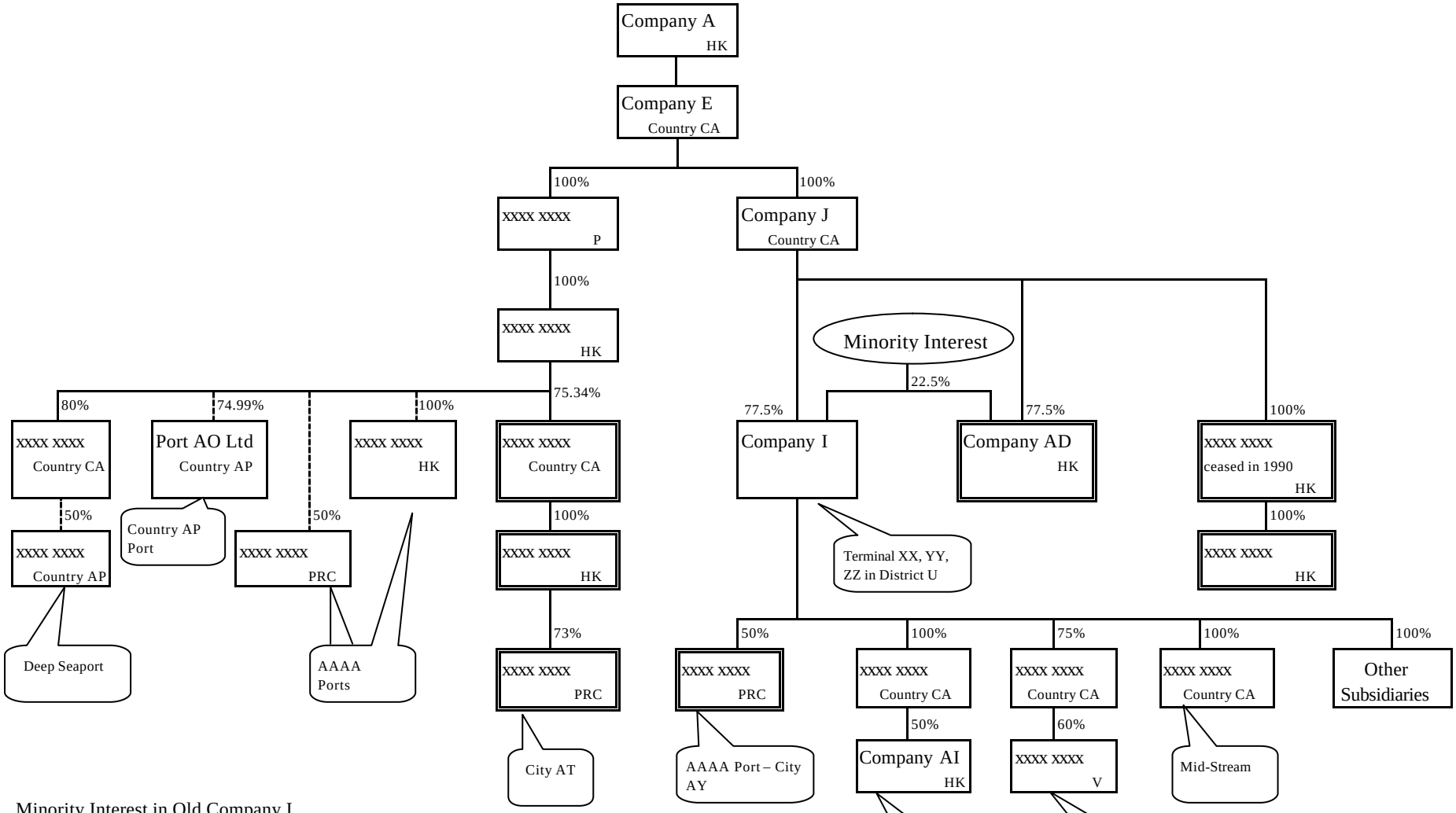
Our decision

91. For these reasons, we dismiss Company P's appeal. We make an order in terms as outlined in paragraph 78 above.

92. We are indebted to all Counsel for their assistance throughout the hearing of this difficult appeal.

Appendix I

Group Structure (Before Regrouping)



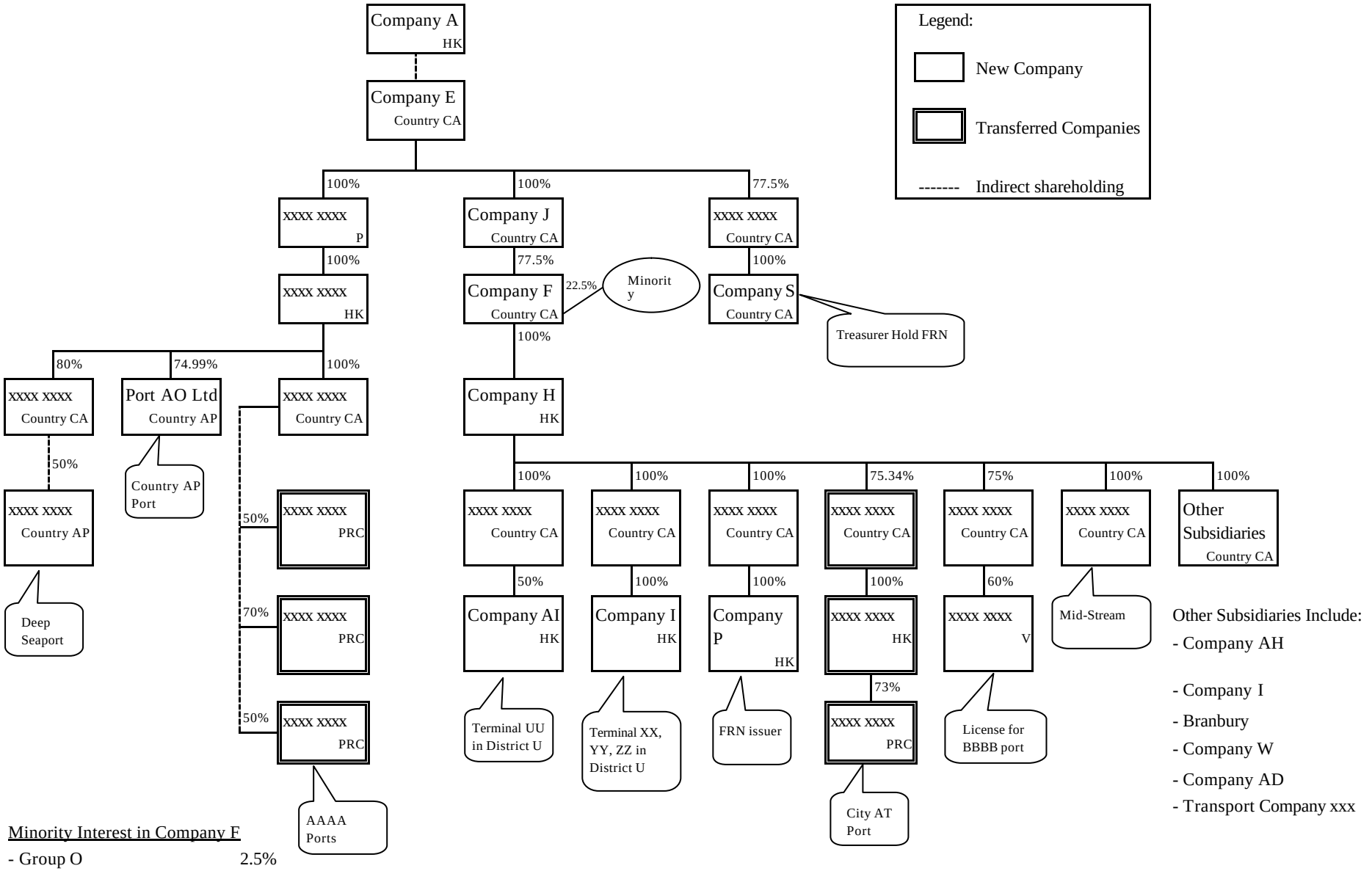
Minority Interest in Old Company I

- Group D	2.5%
- Bank N	5%
- Company K	10%
- Company L	1%

- Company M	4%

Appendix II

Group Structure (After Regrouping)



Minority Interest in Company F

- Group O	2.5%
- Bank N	5%

- Company K	10%
- Company L	1%
- Company M	4%

Appendix III

ALL FIGURES IN US$