Case No. D98/04

Profits tax – whether interest on borrowing deductible – whether borrowing for the dominant purpose of obtaining tax benefit – borrowing was part of a facade – Inland Revenue Ordinance ('IRO') sections 61 and 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 I. This appeal is related to Case No. D97/04 which sets out in full the facts.

The Board made similar findings of facts for the purpose of this appeal.

Held:

1. The Board found the alleged borrowing by Company I from Company P was part of a pre-ordained facade and in substance a claim for interest deduction when no capital sum was involved. Besides, it was a transaction for the dominant purpose of obtaining tax benefit under section 61A of the IRO. Thus, all the interest paid by Company I to Company P should be disallowed.

2. As the alleged borrowing was merely part of the facade to secure an interest deduction, the Board also held that it could be disregarded under section 61 of the IRO.

Appeal dismissed.

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:

1. This appeal is related to the appeal of Company P in appeal No B/R 45/03. We refer to our decision of even date in appeal No B/R 45/03 (Case No D97/04 reported in IRBRD, vol 20, 128) which sets out in full the facts and circumstances leading to the appeals of Company P and Company I, the Appellant in this appeal. The evidence adduced by Company P was adopted by Company I for the purpose of its appeal. We employ the same abbreviations as used in that decision and we make similar findings of fact for the purpose of this appeal.

Section 61A

2. The Revenue identified the following 'transaction' against Company I:

(a) the transaction as identified in the determination which was not pursued before us;

(b) the Narrower Transaction as identified in the Opening Submission of the Revenue dated 23 October 2004 and

(c) the Narrowest Transaction consisting of the alleged borrowing by Company I from Company P.

The production of profit by the operation of the Port has not been included as part of the Narrower or Narrowest Transactions.

3. Mr Goldberg QC submitted that the transaction so defined conferred a tax benefit on Company I as the relevant person in that its taxable profits from operating the Port are lower than what they would have been if it had not been paying 'interest' to Company P on the sum of US$1,148,000,000. Mr Goldberg QC further submitted that Company I has real income. By carrying out the transaction it has undertaken a liability to pay what are in truth imaginary expenses.

4. Mr Gardiner QC submitted that the Revenue's position is untenable as it suggests that Company I can get income from the Port whilst disregarding the financing it required to pay for the Port. We do not agree. The Port was sold pursuant to the Port Purchase Agreement. Under Clause 3, the consideration of HK$23,000,000,000 was divided into three parts. HK$10,394,275,824 was payable upon written demand from Company H. Payment of HK$6,100,000,000 and HK$6,505,724,176 were deferred on terms of various loan notes. Mrs BG failed to throw any light on the demand for and if so the mode whereby HK$10,394,275,824 was paid. On a proper analysis of the facade created by the second paper trail, to the extent of

US$1,148,000,000, no real money was intended to change hands. As a matter of fact all that passed between the parties was the Promise of Company S designed to create in the process the interest deduction in reduction of the tax payable by Company I.

5. Having regard to the fact that the alleged borrowing by Company I from Company P was part of a pre-ordained facade; the fact that it created in form a loan relationship but in substance a claim for interest deduction when no capital sum was involved; the fact that but for section 61A Company I would have secured a reduction of its assessable profits; the fact that the financial position of Company I may reasonably be expected to be weakened by the transaction; the fact that value would move out from Hong Kong in favour of Company S and the fact that between persons dealing with each other at arm's length one would expect real money passing in support of any loan, we conclude that Company I entered into the transaction for the dominant purpose of obtaining a tax benefit.

6. In order to counteract the tax benefit, we are of the view that all the interest paid by Company I to Company P on the alleged principal sum of US$1,148,000,000 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 I dated 26 November 2004.

Section 61

7. Company I did not in fact borrow money from Company P to the extent of US$1,148,000,000. The alleged borrowing was merely part of the facade to secure an interest deduction.

8. We hold that the assessor may disregard such loan and assess Company I accordingly.

9. For these reasons, we dismiss the appeal of Company I and make an order in terms of paragraph 6 above.