

Court of Final Appeal judgment on *Ngai Lik Electronics Co Ltd v CIR* – Pyrrhic victory for the taxpayer in an anti-avoidance case?

■ The Court of Final Appeal (CFA) handed down its judgment on 24 July 2009 on *Ngai Lik Electronics Co Ltd v CIR*, an anti-avoidance case involving the application of section 61A of the Inland Revenue Ordinance¹ (IRO). Experiencing its first setback after a few victories in the anti-avoidance cases brought to the court in the past two years, the Commissioner of Inland Revenue (CIR) lost in this case as the CFA unanimously allowed the taxpayer's appeal. Besides being an

anti-avoidance case, this case also has potentially important transfer pricing implications. This article highlights the relevant facts of the case, summarises the key findings of the CFA and discusses some noteworthy points arising from the CFA's judgment from the general Hong Kong profits tax perspective.

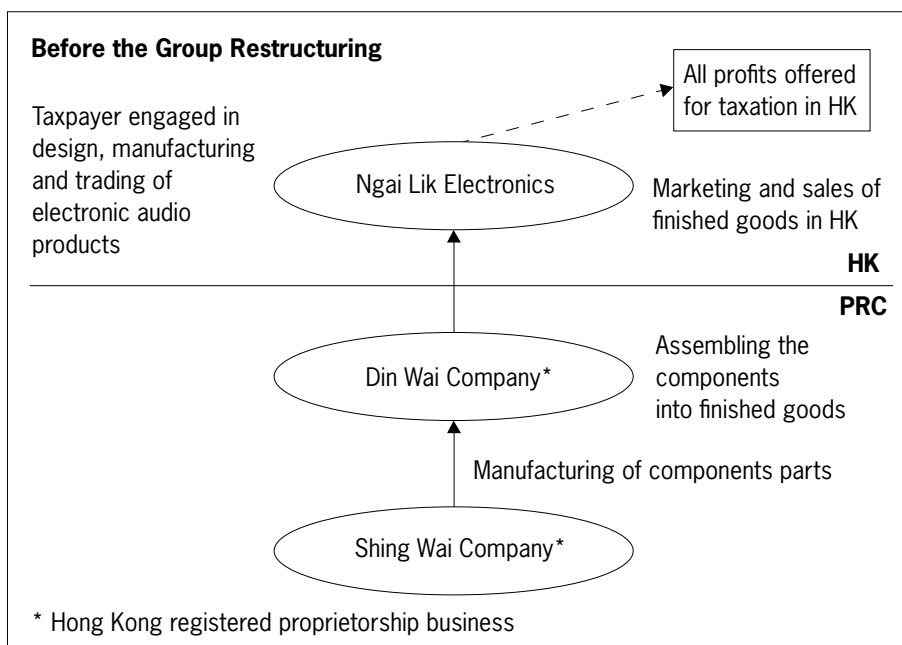
THE CASE

The taxpayer was a company incorporated in Hong Kong and was part of the Ngai

Lik group whose principal activities were design, manufacturing and trading of audio equipment and products. Prior to 1990/91, all of the taxpayer's profits (including manufacturing and trading profits) were offered for profits tax despite the fact that the production was subcontracted to two group companies and carried out in the PRC.

A re-organisation scheme, including listing of the taxpayer's holding company on the Hong Kong Stock Exchange, was carried out by the Ngai Lik group in 1991/92 based on the advice of the group's tax advisor. Under the scheme, three BVI companies were set up, namely Din Wai Electronics Ltd. (DWE), Shing Wai Ltd. (SWL) and Ngai Wai Plastic Manufacturing Ltd. (NWP). The taxpayer would purchase audio equipment ordered by its customers from DWE. DWE would then order the necessary components for the equipment mainly from SWL and NWP and assembled the components in its PRC plant to produce the equipment ordered by the taxpayer.

As part of the scheme, master supply agreements were entered into between (1) the taxpayer and DWE and (2) DWE and SWL/NWP under which the costs paid by the taxpayer and DWE on their purchases from DWE and SWL/NWP respectively should not exceed the purchase costs

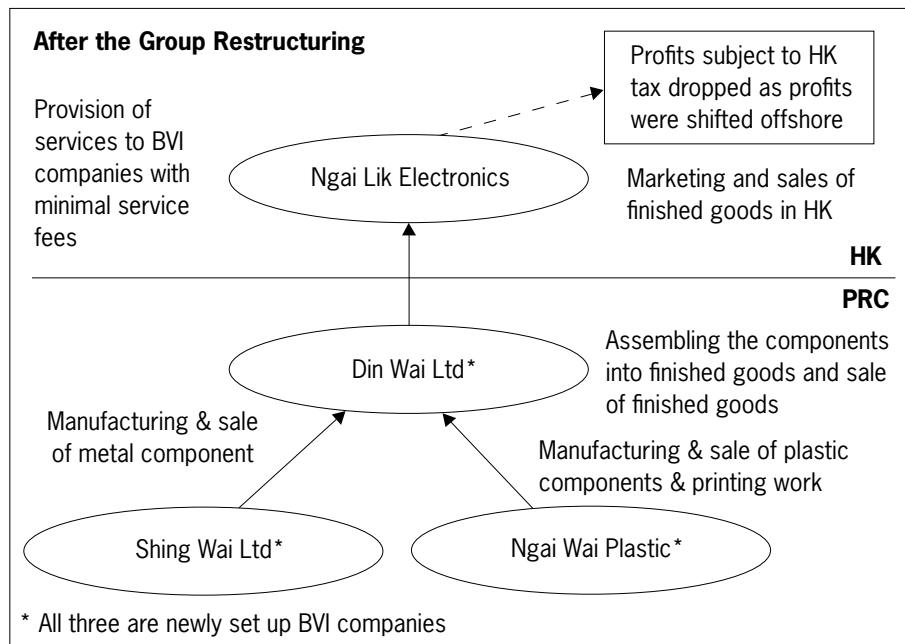


from the cheapest alternative supplier by more than 10%. Service agreements were also entered into between the taxpayer and DWE, SWL and NWP under which the taxpayer would be entitled to charge a service fee with a 5% mark-up of the expenses incurred for the sourcing and agency services performed by the taxpayer to these companies. However, despite the above supply and service agreements, the sale price of the goods sold by DWE to the taxpayer was not set at the times of sales but was subsequently determined by the group's accounting department annually. Bulk sale discounts were also determined annually on an arbitrary basis to spread the profits between DWE, SWL and NWP. In addition, little or no management fees were actually paid by DWE, SWL and NWP to the taxpayer in the years of assessments concerned.

THE CIR'S DETERMINATIONS, THE BOARD'S DECISION AND THE JUDGMENTS OF THE LOWER COURTS

Considering the scheme as a "transaction" having the effect of conferring a tax benefit on the taxpayer, the assessor raised five additional assessments from 1991/92 to 1995/96 on the taxpayer to include the profits of the three BVI companies as the taxpayer's assessable profits from manufacturing operations under section 61A. After re-considering the case, the CIR decided to reduce the profits under challenge by a half in her determination. The taxpayer appealed against the CIR's determinations to the BOR.

The Board accepted the scheme identified by the CIR (the Scheme), which consisted of eight steps and matters, as the relevant "transaction" conferring a tax benefit to the taxpayer under section 61A. These steps include the setting up of the BVI companies, the transfer of business to these BVI companies and the



adoption of the transfer pricing policy after the transfer of business. The Board concluded that the Scheme had the effect of conferring a tax benefit on the taxpayer by reducing the amount of tax as a result of the profits allocation between the companies within the group. The Board found that the annual price-fixing arrangement coupled with the arbitrary additional discounts and insubstantial management fees for services rendered by the taxpayer were the key constituents of the Scheme whereby the taxpayer's assessable profits (and therefore its liability to tax) would be reduced.

On the basis that there was a tax benefit, the Board then considered each of the seven matters specified in section 61A(1) individually, looked at the matters globally and arrived at an overall conclusion that the dominant purpose of the scheme was to enable the taxpayer to obtain a tax benefit. It followed that the five additional assessments on the taxpayer were confirmed.

The Court of First Instance (CFI) upheld the Board's decision and dismissed the taxpayer's appeal on the basis that the

Board was not perverse or unreasonable, in its consideration of the seven matters under section 61A(1), to conclude that the curious pricing mechanism was a means of obtaining tax benefit for the taxpayer. The Court of Appeal unanimously upheld the Board's decision and the CFI's judgment in October 2008.

THE COURT OF FINAL APPEAL'S JUDGMENT

The CFA overturned the Board's decision and the judgments of the lower courts and unanimously allowed the taxpayer's appeal. Below is a summary of the key findings of the CFA.

1. The Scheme and the Tax Benefit formulated by the Board suffer a number of major deficiencies. In particular, the setting up of the BVI companies and the transfer of business to these companies under the Scheme merely represent steps taken in the re-organisation of the taxpayer's business and do not themselves produce any tax benefits for the taxpayer. The only transaction

which could confer tax benefits to the taxpayer was that part of the group's transfer pricing scheme that allowed the pricing between the taxpayer and DWE to be fixed at the year end. In the CFA's view, there are three interlocking conditions (namely transaction, tax benefit and dominant purpose) that must be aligned and approached with the necessary degree of precision for section 61A to be applied properly.

2. In applying section 61A, notional amendment to the Scheme and the Tax Benefit is permissible on the basis that it does not cause any procedural or other unfairness to the taxpayer and therefore, the CFA could proceed with the case focusing on the annual price-fixing arrangement between the taxpayer and DWE and disregarding the other steps in the Scheme.
3. Purchase prices paid by the taxpayer to DWE, though being excessive and not at arm's length, could not be said as not being incurred in the production of the taxpayer's profits and therefore, should be deductible under section 16(1). In addition, deduction of such payments should not be disallowed under section 17(1)(b). In the CFA's view, sections 16(1) and 17(1)(b) do not require the CIR to compare the purchase prices deducted against market prices and to disallow deductions considered excessive.
4. However, as the excessive prices paid are deductible expenses having the effect of reducing the taxpayer's tax liabilities (i.e. a tax benefit to the taxpayer), section 61A was engaged.
5. The CFA agreed with the Board's conclusion that the annual price-fixing arrangement between the taxpayer and DWE was entered into for the dominant purpose of obtaining a tax benefit for the taxpayer. The CIR

could exercise her power either under section 61A(2)(a) to disregard the transaction or under section 61A(2)(b) to counteract the tax benefit conferred to the taxpayer. In the present case, the CIR had evidently chosen section 61A(2)(b) to counteract the tax benefit in question.

6. The power under section 61A(2)(b) must be properly exercised "on the basis of a reasonably postulated hypothetical transaction which produces an assessment designed rationally to counteract the tax benefit". In the present case, the additional assessments on the taxpayer were not validly raised because, importantly, they were based on arbitrary amounts (i.e. treating 50% of the manufacturing profits derived by the BVI companies in the PRC as those of the taxpayer) rather than counteracting the tax benefit obtained from the annual price-fixing arrangement.
7. The CFA held that the group's transfer pricing scheme was in place only at the conclusion of the transfer of business to the BVI companies in 1993 and no such scheme was alleged to have been in existence capable of conferring tax benefits to the taxpayer during years of assessment 1991/92 and 1992/93. Hence, section 61A could only be applicable to years of assessment 1993/94, 1994/95 and 1995/96.
8. Accordingly, the CFA annulled all the additional assessments raised but ordered the case be remitted back to the Board and the Board be directed to remit the case back the CIR to raise fresh additional assessments for years of assessment 1993/94 to 1995/96. Such fresh assessments should be aimed at counteracting the tax benefit and be raised on the basis of a

reasonable estimate of the assessable profits that the taxpayer would have derived if it had hypothetically purchased the goods at an arm's length price.

COMMENTS: APPLICATION OF SECTION 61A

One criticism of the CFA on the additional assessments raised by the CIR is that they represent improper exercise of the power under section 61A. Such criticism was drawn on the basis that the assessments were raised on an arbitrary basis and not targeted at counteracting the tax benefit in question. In the CFA's view, the tax benefit arose from the annual price-fixing arrangement between the taxpayer and DWE without any linkage with the manufacturing profits derived by the BVI companies so there is no basis for treating 50% of those profits as the taxpayer's assessable profits.

The key message from the above is that there is a limit within which the CIR can exercise her power under section 61A to tackle tax-avoidance schemes, namely, such power should be limited to effectively counteracting the tax benefit identified. As such, a reasonable and proper exercise of the power under section 61A will require identification of the tax benefit allegedly conferred on the taxpayer with some precision.

Another major deficiency that leads to the CIR's failure in this case is the misidentification of the relevant transaction that had the effect of conferring a tax benefit to the taxpayer as well as the ill-defined tax benefit. One example of this is that, while the underpayment of management and service fees from the BVI companies to the taxpayer was criticised by the Board and the lower courts (and which might well be a valid criticism given the facts of the case), the same is not a matter

identified either as part of the Scheme or the Tax Benefit formulated, nor is the CIR's additional assessments directed at nullifying or counteracting any tax benefit allegedly obtained by the taxpayer from undercharging for its sourcing and agency services. Another example is the reference to the manufacturing profits in the Tax Benefit. In the CFA's view, referencing to manufacturing profits is totally irrelevant as the tax benefit arose from the annual price-fixing arrangement which reduced the taxpayer's trading rather than manufacturing profits. Accordingly, these criticisms cannot provide any foundation for the additional assessments and are irrelevant to the proper application of section 61A. This demonstrates that a successful application of section 61A by the Inland Revenue Department (IRD) very much hinges on the proper identification of the tax benefit it seeks to challenge and the transaction which gives rise to such tax benefit.

COMMENTS: APPLICATION OF SECTIONS 16(1), 17(1)(B) AND INLAND REVENUE RULE 2A

As mentioned above, although the CFA's judgment is based on the application of section 61A, as a side comment, the CFA made it clear a view that sections 16(1) and 17(1)(b) do not authorise the IRD to disallow deduction of amounts expended for the purpose of producing chargeable profits simply on the basis that the amounts are considered as being excessive or not at arm's length. Rather, excessive deduction could only be challenged by the anti-avoidance provisions in the IRO, in particular, section 61A. The CFA's comment has potentially significant implication to both taxpayers and the IRD as it means that the apparent current practice of the IRD to challenge a deduction claim simply on the ground that the deduction is being excessive or not at

arm's length may not be justified.

However, one should be aware that even though an expense cannot be disallowed merely on the basis that it is excessive, it can conceptually also be disallowed on the basis that it is not incurred for the production of the chargeable profits. For example, if a service fee is paid by a company in return of marketing services provided to both the company and its subsidiary and deduction of the whole amount is being claimed by the company under section 16(1), a portion of the amount paid could be disallowed on the basis that it is incurred for the production of the subsidiary's profits rather than the company's assessable profits.

In determining the reasonable amount that is regarded as expense incurred for producing the assessable profits of a taxpayer, Inland Revenue Rule 2A specifies that apportionment should be made on such basis as is "most reasonable and appropriate in the circumstances of the case". The practical guideline provided in Departmental Interpretation and Practice Notes No. 3 (DIPN 3) on what is meant by the "most reasonable and appropriate basis" is "apportionment can be based on turnover, gross profit, income or assets". In situations such as a cost sharing arrangement, determination of the most reasonable and appropriate basis may involve application of transfer pricing methodologies and principles and so the practical guideline in DIPN 3 may not be that helpful.

CONCLUDING REMARKS

Although the CFA allowed the taxpayer's appeal in this case, a closer look of the judgment would reveal that it is only a partial, and potentially pyrrhic, victory for the taxpayer. The CFA has directed the CIR to raise fresh additional assessments for years of assessment 1993/94 to

1995/96 on the basis of a reasonable estimate of the assessable profits that the taxpayer would have derived if it had hypothetically purchased the goods at an arm's length price (which may be potentially more than the amount the CIR had assessed). Instead of remitting the case to the Commissioner to revise the additional assessments, the CFA annulled the additional assessments and remitted the case to the Commissioner to raise fresh assessments to counteract the tax benefit. Technically fresh assessments on the years of assessments in questions are time-barred under section 60. Assuming fresh assessments can be raised legally, the more significant and far reaching implication from the present case is how the CIR arrives at such reasonable estimate of assessable profits and whether any particular transfer pricing methodology will be adopted in arriving at the estimate. ■

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REFERENCE

- ¹ All the sections in the article refer to the provisions in the Inland Revenue Ordinance (IRO).