

Commissioner of Inland Revenue

*Appellant
(Respondent)*

and

**HIT Finance Limited
Hongkong International Terminals Limited**

*Respondents
(Appellants)*

**Court of Appeal
(Inland Revenue Appeal Nos. 14 & 15 of 2005)**

**Hon Rogers, Tang VPP and Le Pichon JA
Dates of Hearing: 14 - 17 November 2006
Date of Judgment: 13 February 2007**

**Court of Final Appeal
(Final Appeal Nos. 8, 9, 16 & 17 of 2007, Civil)**

**Mr Justice Bokhary PJ, Mr Justice Chan PJ, Mr Justice Ribeiro PJ, Mr Justice
Litton NPJ and Lord Hoffmann NPJ
Dates of Hearing: 14 - 16 November 2007
Date of Judgment: 4 December 2007**

*Tax avoidance – profits tax - deduction of interest expenses – issue of loan notes in excess
of what was on offer in the market and the introduction of an offshore group
company to instantly return back two-thirds of the money – whether giving rise to
a tax benefit – whether sole or dominant purpose was to obtain a tax benefit -
Inland Revenue Ordinance (Cap. 112) section 61A*

In 1994 Hutchison Whampoa Limited (HW) decided to reorganise the structure of its group which owned and operated container terminals and other port facilities. It also wanted to borrow about US\$1.735 billion in the market for the acquisition and development of additional port facilities on the mainland and elsewhere. Hongkong International Terminals Limited (HITL) was formed to purchase the container terminal business and other related assets in Hong Kong and HIT Finance Limited (Finance) was incorporated as the vehicle through which to borrow money. Finance would then borrow the US\$1.735 billion by issuing loan notes quoted in Luxembourg.

The market conditions for borrowing in Hong Kong were adverse and that it could raise only US\$587 million, about one third of the required amount. HW nevertheless went ahead with the full US\$1.735 billion issue by Finance on the footing that it would, through a subsidiary, subscribe for the amount which the syndicate of underwriters would not underwrite. In other words, HW was to borrow US\$1.735 billion subject to the condition that it immediately gave two-thirds of the money back. Strategic Investments International Limited (Strategic) was acquired to be the vehicle for giving back the money and to hold US\$1.148 billion worth of notes.

Thereafter, HITL deducted the interest which it paid Finance on the US\$1.721 billion it had borrowed. Finance in turn deducted the interest paid to Strategic as holder of the notes it had issued. Finance paid tax on the profit it had made on the difference between its borrowing and lending rates. Strategic was not liable to tax on the interest which it received from Finance because it was a BVI company and, in any case, the loan notes issued and quoted in Luxembourg were an overseas source of income.

The Commissioner disallowed the deduction of interest by Finance and HITL on that part of the loan proceeds represented by the notes acquired by Strategic pursuant to sections 16(1)(a), 17(1), 61 and 61A of the Inland Revenue Ordinance (IRO). She considered that in reality Finance did not borrow the money at all. It simply went around in a circle. Alternatively, she considered that the borrowing was an artificial or fictitious transaction or that the transaction had the effect of conferring a tax benefit on Finance and HITL and had been entered into for the sole or predominant purpose of enabling that tax benefit to be obtained.

On appeal, the Board of Review accepted the Commissioner's submissions and dismissed the appeals by Finance and HITL. Finance and HITL appealed directly to the Court of Appeal against the Board of Review's decisions. The Court of Appeal allowed their appeals and remitted the case to the Board of Review to consider the purpose of the parties under section 61A of the IRO. The Commissioner appealed to the Court of Final Appeal whereas Finance and HITL cross-appealed against the remittal.

Held, allowing the appeal against HITL and dismissing the appeal against Finance, that:

- (1) A tax benefit simply means a difference favourable to the taxpayer between his tax liability computed on one basis and his liability computed on a different basis.

- (2) A transaction with terms or features which reduce the taxpayer's liability, compared with what it would have been without them, confers a tax benefit upon him. If those terms or features were included for the sole or predominant purpose of securing that benefit, the Commissioner may counteract that benefit under s.61A(2)(b) by assessing him on the basis that the transaction took the form it might reasonably be expected to have taken without those terms or features.
- (3) The borrowing of US\$1.721 billion, instead of the US\$587 million that was actually on offer, together with the introducing of Strategic into the transaction for the purpose of enabling US\$1.148 billion of the borrowing to be instantly returned, had the effect of conferring a tax benefit on HITL, namely the ability to compute its tax liability after deducting from the profits of its container terminal and port business a far larger sum of interest than it would have done if it had borrowed only US\$587 million.
- (4) It is common for groups of trading companies to have a treasury company. The curious feature of the HIT group was that it had two treasury companies. Finance was obviously originally intended to have that role and does not appear to have done anything except borrow and lend money. Why was Strategic introduced as well? When one considers how the scheme was carried out, it is impossible to avoid the conclusion that the sole or predominant purpose was to secure the tax benefit by holding the loan notes, an overseas source of income, in an offshore company.
- (5) The Board of Review was entitled to find that borrowing the larger amount and introducing Strategic as the means of returning two-thirds of it conferred a tax benefit and that the transaction in that respect was entered into solely or predominantly for the purpose of obtaining that benefit.
- (6) The Commissioner was entitled to take appropriate steps to counteract the tax benefit conferred by the impugned transaction. She fully achieved that object by disallowing the deduction of interest on the borrowing of HITL from Finance in excess of the net proceeds of the loan note issue actually received by the group. Any disallowance of deductions by Finance as well would go further than counteracting the tax benefit and would not be appropriate.

In the Court of Appeal and Court of Final Appeal

Mr David Goldberg QC & Mr Stewart KM Wong, instructed by the Department of Justice,

for the Commissioner

Mr John Gardiner QC, Mr Ambrose Ho, SC and Mr Kenny Lin, instructed by Messrs Woo, Kwan, Lee & Lo, for the taxpayers

Cases referred to in the judgment of the Court of Final Appeal:

MacNiven v Westmoreland Investments Limited [2003] 1 AC 311

Barclays Mercantile Business Finance Limited v Mawson [2005] 1 AC 684

CIR v Tai Hing Cotton Mill (Development) Limited, FACV No. 2 of 2007