The Offshore Tax Planning Review

HONG KONG: THE ANTI-AVOIDANCE TIME BOMB

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Introduction

In 1986 the Hong Kong Government enacted a general anti-avoidance provision, s.61A of the Inland Revenue Ordinance. This section was intended to curb the increasing use of blatant or contrived tax avoidance arrangements imported for high tax jurisdictions. The section applies to any transaction entered into after 13th March 1986 for the sole or dominant purpose of enabling a person to obtain a tax benefit. Where it applies the section provides for an assessment to be made as if the transaction had not been entered into or carried out, or in whatever manner is necessary to counteract the tax benefit. The section is derived from similar legislation in New Zealand and Australia.

Practical Operation of the Section

Although it is now more than six years since s.61A came into force there is, at the time of writing, only one reported decision of the Board of Review involving the use of the section by the Revenue. No cases involving the section have been considered by the courts. The section has been used in negotiations with taxpayers to achieve settlements favourable to the Revenue. In general, the approach of the Revenue has been to avoid the use of s.61A in situations likely to result in litigation if there was a significant risk of the taxpayer winning and the Board or, on appeal, the courts interpreting the section restrictively.

Recently, however, two cases have been heard by the Board of Review in which s.61A has been invoked. Only one decision has so far been published. It is, however, known that the taxpayer lost in both cases. It is believed that there are between fifteen and twenty further cases set down for hearing by the Board of Review.

The parallel Australian anti-avoidance legislation, which was enacted in 1981, produced its first reported case in 1992 which the taxpayer lost at first instance but

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won on appeal with all three Judges holding that the transaction had been carried out primarily for genuine commercial reasons. While the facts of the Australian case are irrelevant to Hong Kong there are a number of general matters worth noting. The first is that, like Hong Kong, it has taken many years for the legislation to be considered by the courts. However, this does not mean that the legislation will not be applied in appropriate cases. The reality is that it takes time before a case arises in which a taxpayer decides that there is a chance of winning and the matter is taken to appeal. The second is that the Australian case arose from information obtained from a field audit. Hong Kong's Inland Revenue Department commenced field audits in June 1991 and already this new procedure has uncovered significant tax evasion. It seems likely that it will also uncover unacceptable tax avoidance. It follows that as field audits are extended in scope s.61A assessments can be expected to increase in number. However, as the Australian case also points out, transactions carried out for genuine commercial reasons which are adjusted to achieve ancillary tax advantages are not within the scope of the general anti-avoidance legislation. The same appears to be equally true of s.61A.

The Responses of Tax Practitioners

There appear to have been two main responses from tax practitioners to s.61A, in particular from the more aggressive tax planners. The first has been to subject the section to a close and sometimes over-literal analysis in an attempt to expose the section's technical limitations. The second has been to take a risk and to proceed with a tax planning scheme in the hope that it will not be challenged and in the belief that, even if it is, and the Revenue succeed in a s.61A assessment, a deferral advantage will be gained. Both approaches may well prove to have been misguided.

It is now clear that courts are increasingly reluctant to allow strict literal construction of the words used in anti-avoidance legislation to frustrate the intention of the legislature. In Hong Kong the Interpretation and General Clauses Ordinance requires legislation to be construed in the way that will best ensure its object "according to its true intent and spirit." It is therefore quite possible that Hong Kong judges will adopt the approach of Lord Bridge in *IRC v Garvin* [1981] STC 344 at 352, namely that anti-avoidance legislation "being aimed at the multiplicity of ingenious schemes which are constantly being devised to evade taxation should not be construed on the principle that the subject is not to be taxed except by plain words but by giving such a wide interpretation to the language used as may be necessary to give effect to the evident intention of Parliament." A strict literal interpretation of s.61A is therefore unlikely to avail a taxpayer in cases where blatant or contrived tax avoidance planning has been undertaken.

The view that there is nothing to lose from giving a tax planning scheme "a go" is not without risk. If the scheme fails under s.61A following an unsuccessful appeal, and the taxpayer has, without reasonable excuse, made incorrect statements or not provided information, there is a risk of penalty tax being assessed of up to three times the tax due. If an appeal to the courts is unsuccessful the taxpayer would in most cases have to pay the Revenue's legal costs as well as his own. The courts have on several occasions stressed the dangers for those who advise on elaborate tax avoidance schemes if the change of attitude to tax planning of legislators and the courts is ignored. In a recent UK court decision, involving the leasing of capital assets and the exploitation of capital allowances, the court thought that the scheme involved "unacceptable tax avoidance" and described it as "a raid on the Treasury using the technicalities of revenue law". In the context of Hong Kong with its low rates and relatively simple tax system, elaborate tax planning schemes might understandably be viewed as even more "unacceptable".

A further danger was also revealed in the second, as yet unreported, Board of Review decision referred to above. Not only did the Board apply s.61A, they also applied s.61 which permits the Revenue to disregard a transaction which is "artificial or fictitious". As the case involved a scheme involving the assignment of royalties to an offshore tax haven company, which has become common since the late 1980s, the ramifications are significant. This is so not only in relation to this particular scheme but also because s.61, which was thought even by the Revenue to be defective, has made a rigorous comeback. As a post script it should be mentioned that the so-called royalty assignment schemes have come under further attack from the Government and will be targeted by specific anti-avoidance legislation with retrospective effect from 3rd March 1993.

Conclusion

The first s.61A cases are just beginning to reach the Board of Review, the first level of tax appeals in Hong Kong, and s.61 has been used to disregard artificial transactions carried out for tax planning reasons. It seems likely that many of the tax planning schemes imported into Hong Kong from high tax jurisdictions in the 1980s will fall apart as they are considered by the Board and the courts. There are problems ahead for some taxpayers and their professional advisers.