The numerous legal decisions on the matter were considered by the Royal Commission on the Taxation of Profits and Income which reported in 1955 in the United Kingdom. The main relevant factors to be examined were conveniently summarised under what the Committee referred to as the six "badges of trade." Their verbatim description of these is as follows:—

"(1) The subject matter of the realisation. While almost any form of property can be acquired to be dealt in, those forms of property, such as commodities or manufactured articles, which are normally the subject of trading, are only very exceptionally the subject of investment. Again property which does not yield to its owner an income or personal enjoyment merely by virtue of its ownership is more likely to have been acquired with the object of a deal than property that does.

(2) The length of the period of ownership. Generally speaking, property meant to be dealt in is realised within a short time after acquisition. But there are many exceptions from this as a universal rule.

(3) The frequency or number of similar transactions by the same person. If realisations of the same sort of property occur in succession over a period of years or there are several such realisations at about the same date a presumption arises that there has been dealing in respect of each.

(4) Supplementary work on or in connection with the property realised. If the property is worked up in any way during the ownership so as to bring it into a more marketable condition; or if any special exertions are made to find or attract purchasers, such as the opening of an office or large-scale advertising, there is some evidence of dealing. For when there is an organised effort to obtain profit there is a source of taxable income. But if nothing at all is done, the suggestion tends the other way.

(5) The circumstances that were responsible for the realisation. There may be some explanation, such as a sudden emergency or opportunity calling for ready money, that negatives the idea that any plan of dealing prompted the original purchase.

(6) Motive. There are cases in which the purpose of the transaction of purchase and sale is clearly discernible. Motive is never irrelevant in any of these cases. What is desirable is that it should be realised clearly that it can be inferred from surrounding circumstances in the absence of correct evidence of the seller's intentions and even, if necessary, in the face of his own evidence."

It is sometimes suggested that the approach in the *Simmons* case (above) is different to an analysis based on the badges of trade. This is not, however, the case as an examination of the badges of trade is merely an exercise aimed at ascertaining the taxpayer's intention. This was confirmed by the Board of Review in *D 65/87*,[17] which was quoted with

17. 3 IRBRD 66.

approval by the Court of First Instance in *Real Estate Investments (N.T.) Ltd v CIR*,[18] where it stated:—

"We see no inconsistency between Lord Wilberforce's statement in Simmons and the badges of trade approach. For there to be an adventure in the nature of trade, an intention to trade is required. In deciding whether there was such an intention, one must look at all the circumstances and examine whether the transactions bore any of the badges of trade. If the transaction bore the badges of trade, it would mean that an intention to trade was present notwithstanding protestations by the Taxpayer to the contrary."

The decision of the Court of First Instance was upheld by the Court of Appeal.[19]

The question has come before the courts in Hong Kong on numerous occasions.[20]

For a discussion on the special circumstances of an insurance company which owns real property, see *CIR v Sincere Insurance & Investment Co. Ltd*[21] Insurance companies are, in general, regarded as holding real estate or shares on revenue account if those assets are held as part of their insurance reserves. This is also true of banks and other financial institutions, although the contrary can be proved in appropriate circumstances.[22] See also the Privy Council decision in the case of *CIR v Waylee Investments Ltd*[23] where the question turned upon whether banking motives can be attributed to a non-banking subsidiary of a bank. The Privy Council's decision was to the effect that not only can the banking motive not be automatically assumed to be applied within a bank's subsidiary company, but that it is quite open for a bank itself to hold investments as long-term

18. [2006] 1 HKLRD 652.
19. (2008) 11 HKCFAR W 33.
20. See, for example, *CIR v Jebsen & Co* (1949) 1 HKTC 1, *Wing On Cheong Investment Co Ltd v CIR* (1987) 3 HKTC 1, *Richfield International Land and Investment Co Ltd. v CIR* (1989) 3 HKTC 167, *Beautiland Co Ltd v CIR* (1991) 3 HKTC 520, *All Best Wishes Ltd v CIR* supra, and *Chanway Investment Co Ltd v CIR* [1998] 1 HKC 712). For two more recent cases on the topic which contain particularly interesting discussions on how various factual and evidentiary matters are considered in determining whether a trading intention existed, see *Brand Dragon Ltd and Harvest International Ltd v CIR* [2002] 1 HKC 660, and *Stanwell Investments Ltd v CIR* [2004] 2 HKLRD 227.
21. (1973) 1 HKTC 602.
22. 1 IRBRD 345.
23. [1991] 1 HKLRD 237.

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capital investments. Whether it does so or not in given circumstances is a question of fact to be judged on the evidence.

There are also numerous Board of Review decisions where the principle of whether or not a transaction is an adventure in the nature of a trade has been discussed. Many of these cases involve individuals who have bought and sold real estate at a profit, and in the majority of those cases the individuals have been found to be trading and, therefore, assessable on their profits. It must be remembered, however, that not all trading results in a profit and, if a transaction which amounts to an adventure in the nature of a trade results in a loss, that loss would generally be deductible. The IRD is, however, often reluctant to allow a deduction for such losses and can be expected to critically examine any such claims in order to determine their validity. Nonetheless, it was interesting in *D25/04*[24] that the IRD attempted to deny a deduction for losses to an individual who had an established history of property trading and who had been previously assessed on his profits. Quite correctly, the Board of Review found for the taxpayer and allowed the losses. See also *D117/01*[25] where a deduction was allowed for a loss arising out of a forfeited deposit and estate agent commissions where a taxpayer failed to complete a contract for the purchase of a property.

Another Board of Review case is where the necessity to sell newly developed properties to repay development finance was not regarded as necessarily importing a trading intent.[26]

Another decision of note is *D142/00*.[27] In that case, a company was held to be trading in shares of an offshore incorporated subsidiary and, therefore, taxable on the profit derived from the disposal thereof. What is of particular interest about this decision was that the situation was not a typical trading scenario. Rather, the transaction was one structured so as to avoid a Hong Kong stamp duty liability arising on the disposal of the taxpayer's 50% interest in a Hong Kong company which owned real property. More specifically, the taxpayer owned Company H, which in turn owned one of two issued shares in the Hong Kong company (Company G). In order to effect the disposal of its interest in Company G, the taxpayer acquired the sole share in the offshore company (Company J) for US$1. Company G then issued 9,998 new shares at their par value of US$1 each;

24. 19 IRBRD 206.
25. 16 IRBRD 898.
26. *D60/87 3* IRBRD 24.
27. 16 IRBRD 28.

of these, 4,999 were issued to Company J, with the remainder being issued to the party which held the other 50% interest in company G. Company H then sold its single share in Company G, which due to the above share issue represented only 0.01% of the issued capital of Company G, to Company J. The taxpayer then sold its share (representing the entire interest) in Company J for a substantial sum.

The Board of Review, in finding for the Commissioner, rejected the taxpayer's argument that it had no intention to trade in the shares of Company J. Rather, the Board noted that the share in Company J was acquired with the express intention of being resold at a profit and that there was never a change in that intention. As such, the Board held that the acquisition and disposal of the Company J share was a trading transaction. Although the Board recognised that the transaction was in substance a means of disposing of its interest in the property held by Company G, it refused to decide the case by looking beyond the transaction in Company J shares. Moreover, the Board held that, in computing the assessable profit derived from the disposal of the Company J share, it was not possible to deduct the value of the shares in Company G which were effectively gifted to Company J. As a result, the taxpayer was assessable on the consideration received for selling the Company J share, less the US$1 it had paid for the share. This gave rise to a Profits Tax liability of more than HK$23.3 million, which far outweighed the Stamp Duty saving achieved of approximately HK$848,000.

In the case of whether or not a sale of land or buildings comprises a trade of dealing in land, the onus of proof by the taxpayer that it does not comprise such a trade is much harder to meet where the taxpayer is an acknowledged land trader or where his audited accounts indicate that the land or buildings had been held as current assets.[28] Merely stating properties in the financial accounts to be fixed assets, however, is not conclusive of that fact unless there is other evidence to support it. Furthermore, acceptance of a Profits Tax assessment on any profit on sale, no matter how small or insignificant the transaction may have been, may imply that the properties remaining may also be regarded by the owners as current assets, and this may be the case even where it can be proved that they were originally acquired as fixed assets.[29]

28. *Central Enterprises Ltd v CIR* (1987) 2 HKTC 240, and *Chinachem Investment Co. Ltd v CIR* (1987) 2 HKTC 261.
29. *Richfield International Land and Investment Co. Ltd. v CIR* (1989) 3 HKTC 167.

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Ultimately, however, this is still a question of fact to be decided in each particular case. For an example of where a contrary conclusion was reached to that of the *Richfield* case,[30] see *D104/01*.[31] In that case, the taxpayer had developed a building and sold the majority of the units in the 1970s; when one of the unsold units was subsequently sold in 1996, the IRD attempted to assess the gain relying on the fact that the taxpayer had accepted the assessments on the profit earned from the sales in the 1970s. In finding for the taxpayer, however, the Board of Review decided on the basis of the evidence that the taxpayer had never held an intention to trade in the units which were not sold in the 1970s.

Notwithstanding the necessity to produce positive evidence of intention, it is nevertheless not open to the Board of Review to speculate upon a taxpayer's intentions. In particular, the Board cannot decide that a company appropriated property from fixed to current assets just because it sold the property.[32]

In the case of profits from the purchase and sale of shares, it is difficult to lay down general rules as to whether these arise from a share trading activity.[33] The majority of cases has concerned individuals who sought to deduct losses from share transactions but which the IRD denied on the basis that no share trading business existed. It appears from those decisions that the IRD and the Board of Review generally consider that speculative transactions in shares by an individual do not amount to a trade (in the absence of something that looks like an organized business structure), although it is recognised that each case needs to be considered on its own merits.

For example, in *D74/00*[34] the Board of Review stated that where an individual was engaged in speculative dealings, there was a *prima facie* assumption that he was not carrying on a business. Similarly, in *D61/04*[35] the Board again noted that it was a question of fact whether a person is carrying on a trade or business, but went on to conclude that pure

30. Ibid.

31. 16 IRBRD 847.

32. *Wing On Cheong Investment Co Ltd* v CIR (1987) 3 HKTC 1.

33. See, however, *CIR v Dr. Chang Liang-Jen* (1977) 1 HKTC 975, *D30/84* 2 IRBRD 152, *D111/97* 13 IRBRD 20, *D74/00* 15 IRBRD 670, and *Lee Yee Shing, Jacky* [2008] 3 HKLRD 51; FACV 14/2007; [2008] 2 HKC 436; (2008) 11 HKCFAR 6, for discussions of the principles involved.

34. Above.

35. 19 IRBRD 557.

speculation is a factor which weighs against such a finding. In that case, the Board held that the taxpayer's activities did not amount to a trade or business, and this decision was ultimately upheld by the Court of Final Appeal in the *Lee Yee Shing* case. The Court of Appeal judgment is interesting[36] because the taxpayer sought to argue that the test applied by the Board of Review was wrong because it treated speculation as the antithesis of trading, whereas this was not consistent with earlier UK case law, and that once the Board found that the taxpayers were speculators it concluded that they could not have been trading. The taxpayer's argument in this regard was based on the fact that the statutory definition of "*trade*" includes an "*adventure and concern in the nature of a trade*" and that the effect of this was to enlarge the meaning of trade to include speculation. Although it seems that, as in previous decisions, the Board of Review was inclined to consider speculation and trading as opposites, the Court of Appeal reiterated that the Board was in fact only noting that the presence of speculation was a factor which weighed against a finding that a trade or business was being carried on where there was no systematic conduct of the activity, but that the question was ultimately to be decided by considering all relevant factors. While this decision clearly established that trading and speculation are not to be considered as mutually exclusive alternatives, unfortunately it did not explain why the argument on behalf of the taxpayers that speculation must in fact be trading was not accepted.

This point was more fully dealt with by the Court of Final Appeal which took the view that the mere fact that an asset was acquired with an intention to dispose of it at a profit was insufficient by itself to render that activity a trade. The court observed more broadly that the fact that an undertaking had a profit-making purpose, although an indicator of a trade or business, is not determinative of the question. Additionally, the court considered that speculation was akin to gambling, which it noted had generally been found not to amount to a trade unless undertaken by a person with some special knowledge of the particular activity or industry which was the subject of the speculation. Equating speculation and gambling in this way tends to treat speculation as the antithesis of trading which, as discussed above, is how the matter has been traditionally viewed by the IRD and the Board of Review, although the court did again emphasise the need to decide each case on its own merits.

Aside from the question of the relationship between speculation and trading, *D61/04* and the subsequent *Lee Yee Shing* are also notable for

36. (2007) CACV 180/2006.

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highlighting the difficulty an individual faces in establishing that his share transactions amount to a trade or business. In that case, the IRD and the Board of Review found that the appellant was not carrying on a trade despite the existence of evidence that, during the relevant period, he entered into hundreds of transactions each year, his average holding period for the shares was relatively short (between 42 and 95 days), he had direct telephone lines to the dealing rooms of two securities firms and he was a majority owner of a securities broking firm for a part of the relevant period.

The reluctance of the IRD to accept speculative share transactions as trading is interesting considering that the IRD actively pursues taxpayers in respect of speculative real estate trading transactions, as is evidenced by the large number of Board of Review cases each year concerning such activities. In particular, the factors looked to in order to ascertain whether a share trading business exists (e.g. systematic approach, number of transactions, extent of research, quality of business records, etc.) would appear to be equally relevant, but often even less evident, in the case of speculative property transactions than with share transactions. One possible reason for this practice is that the IRD finds it easier to collate comprehensive information on property transactions because of the title registration system, than in the case of share transactions, although it is not clear why this should be a relevant consideration in determining whether a trade is being carried on. It is often surmised that the IRD is reluctant to find a share trading business existing because the result would be likely be that more taxpayers would be seeking to deduct losses rather than pay tax.

This distinction between the treatment of real estate and share transactions was noted in *D74/00*[37] where the Board of Review held that the principle established in the *Simmons* case[38] of looking to see the intention of the taxpayer on acquisition of an asset was applicable only to transactions in real property, and that in the case of transactions involving shares other factors must be looked to in determining whether a trade exists. The Board went on, in fact, to conclude that with any dealing in shares or securities there was a *prima facie* assumption that the activity did not amount to a trade. These conclusions appear to stem from comments in earlier Board of Review cases, although there is no reference to any higher judicial authority regarding the matter. The Court of Final Appeal

37. Above.
38. Above.

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in the *Lee Yee Shing* case also noted this apparent anomaly but concluded that it was justified on the grounds that, because of the higher degree of volatility in share prices, such transactions are (as discussed above) generally to be viewed as akin to gambling which is typically not considered to amount to a trade.

Where an established property trading group of companies sells shares in subsidiaries holding trading property, it does not follow that the trading motive should be assumed to be imported into the share transactions as well. It is not normally the case that a group trades in its subsidiaries, and the trading activities of a subsidiary are arguably not relevant to the issue of whether the shares in such subsidiary constitute trading assets.[39]

Similarly, the intention of the shareholders with regard to the holding of their shares should not be imported into the intention of the company with regard to its assets. See, for example, *CIR v Quitsubdue Ltd*[40] where the issue was whether a property being redeveloped by the taxpayer had been acquired as a capital or trading asset and whether that intention had subsequently changed when the company's shareholders changed. In overturning the decision of the Board of Review and finding that the asset had always been a capital asset of the company, the Court remarked that the Board of Review had incorrectly equated the company's intention with that of the shareholders. That is, the fact that the shareholders may have intended to dispose of their indirect interest in the property by means of a sale of the shares was not relevant in deciding the intention of the company itself with regard to the property.

An interesting question which sometimes arises concerns whether assets acquired and held as part of a leasing business, but which may be sold at the end of a lease or at some other time, should be seen as capital assets or trading stock. As with all capital versus revenue questions, this is largely a question of fact heavily dependent upon the intention of the taxpayer. Nonetheless, in other jurisdictions there has been a tendency to categorise such assets as trading stock.[41]

39. In this connection, see *Beautiland Co Ltd v CIR* (1991) 3 HKTC 520, and also *D 65/87 3 IRBRD 66*.
40. [1999] 3 HKC 233
41. See *Gloucester Railway Carriage and Wagon Co Ltd v IRC* (1925) 12 TC 720, *FC of T v Cyclone Scaffolding Pty Ltd* (1987) 19 ATR 674, and *Memorex Pty Ltd v FC of T* (1987) 19 ATR 553; in the only reported Hong Kong decision on the question, *D 31/92* 7 IRBRD 303, a similar view was taken.

The fact that the activity giving rise to a profit may be illegal does not disqualify it from being taxable. See, e.g., *Mann v Nash*[42] concerning profits made from the illegal operation of gaming machines.

2.3.4 Meaning of business

The scope of Profits Tax extends to the carrying on of "business." Delivering the advice of the Privy Council on appeal from Malaysia in *American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue*,[43] Lord Diplock said in terms that business is a wider concept than trade.

Sec. 2(1) contains the following inclusive definition of "business":—

> *"agricultural undertaking, poultry and pig rearing and the letting or sub-letting by any corporation to any person of any premises or portion thereof, and the sub-letting by any other person of any premises or portion of any premises held by him under a lease or tenancy other than from the Government."*

It was recognised in *Lee Yee Shing* that business is a wider concept than trade. In commenting on what constitutes a business McHugh NPJ stated that no definition or ordinary meaning can be universally applied. He went on to say,

> *"Nevertheless, ever since Smith v Anderson [1880] (15 Ch D 247), common law courts have never doubted that the expression 'carrying on' implies a repetition of acts and that, in the expression 'carrying on a business,' the series of acts must be such that they constitute a business: Smith v Anderson [1880] (15 Ch D 247) at 277–278 per Brett LJ. Much assistance in this context is also gained from the statement of Richardson J in Calkin v Commissioner of Inland Revenue [1984] (1 NZLR 440) at 446 where he said 'that underlying . . . the term 'business' itself when used in the context of a taxation statute, is the fundamental notion of the exercise of an activity in an organised and coherent way and one which is directed to an end result'."*

Note, therefore, that a corporation which lets any property is automatically regarded as carrying on business whereas any other person is normally not so regarded unless he sub-lets property. In other words, letting by a government leaseholder (who is regarded as the "owner" under the IRO) who is not a corporation is not necessarily regarded as carrying on business. However, care should be exercised in applying the definition in Sec. 2 because it is only stated to "include" the things which it mentions and, therefore, its scope can be much wider. Although the decision in *Lam Woo Shang v CIR*[44] was superseded by a change in the

42. 16 TC 523.
43. [1979] AC 676, [1978] 3 WLR 985.
44. (1961) 1 HKTC 123.

definition of "business" in Sec. 2, it nevertheless contains a good summary of the principles involved in defining that word. As already mentioned, an individual letting a property is not normally regarded as carrying on a business but will be subject to Property Tax. In *Louis Kwan-nang Kwong, Carlos Kwok-nang Kwong v CIR*,[45] however, two individuals letting out a cinema as a going concern were held to be carrying on a business subject to Profits Tax. Also, an individual who sub-lets real estate automatically falls within the definition of business in Sec. 2.

■ Example 2.1

Mr. O. Nurr owns a flat which he lets to Mr. Smarty at $75,000 per annum who immediately sub-lets it to Mr. A. Sucker for $100,000 per annum. Rates of $5,000 per annum and repairs are paid by Nurr.

O. Nurr is not carrying on business and therefore pays Property Tax on $56,000 (i.e. ($75,000 – $5,000) × 80%).

Smarty is carrying on business and pays Profits Tax on $25,000 profit.

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Whereas "trade" and "profession" are normally associated with some active function, the wider term "business" can include circumstances where there is a purely passive receipt of income. For example, a holding company whose function is solely to hold shares in other companies, even subsidiaries, is carrying on a business whether or not there is any active management participation in the companies in which it has interests. For an examination of the principles in borderline cases, see *IRC v Korean Syndicate*.[46] Because of the wide definition of business, it is possible for a corporation to commence business before it commences trading.

The ascertainment of whether or not a corporation is carrying on a trade or business is most significant in the cases where it is in receipt of Hong Kong source interest. If it is carrying on a trade or business, it is liable to Profits Tax on its net profits after deducting relevant expenses but, if it is not carrying on a trade or business, it is not so liable. This leads to the question of whether the mere depositing of money can constitute a business. There have been a number of cases on this question in other jurisdictions and it is clear that it is a question that can only be answered on the facts of each particular case. It is much more difficult for a company to establish that its depositing activities do not constitute a business than in the case of an individual as there is a presumption (which can

45. (1989) 2 HKTC 562, [1989] 2 HKLRD 326.
46. [1921] 3 KB 258, 12 TC 181.

possibly be rebutted) that anything a company does amounts to a business: see *American Leaf Blending*. In DIPN 13, however, the IRD states that the mere depositing of money by a corporation will not amount to the carrying on of a business, but that actions beyond "mere passive acquiescence" may constitute the carrying on of a business. Additionally, the IRD suggests that a period of inactivity does not rebut the fact that a company is still carrying on business. Accordingly, a company which ceases to trade but continues to passively deposit money is likely to be considered by the IRD to be carrying on a business. For cases where the Board of Review in Hong Kong has considered this question, see *D15/87*, *D33/91* and *D27/93*.[47]

Although under the mutuality principle bodies such as clubs, trade associations and mutual insurance corporations are not regarded as carrying on business to the extent that they trade only with members, Sec. 24 deems clubs and trade associations as carrying on business for Profits Tax purposes in certain circumstances (see section 6.9). Further, Sec. 23AA deems mutual insurance corporations to be subject to Profits Tax (see section 6.3).

2.3.5 Commencement of business

The date of commencement is largely a question of fact. For example, a retail shop would generally be considered to commence business when it first acquires trading stock or opens its doors to the public. In the case of a manufacturing business, it was held in *Birmingham & District Cattle By-Products Co Ltd v IRC*[48] that acts such as research, the construction of buildings, the acquisition of plant and machinery and the entering into of agreements with suppliers were of a preparatory nature only and the "trade or business" did not commence until the company commenced to acquire raw materials for processing into its products. This approach of disregarding preparatory acts in determining when business commenced was followed by the Board of Review in *D3/86*.[49]

The mistake should not be made of looking for the first sale or receipt of income because this may be a long time after commencement of the business leading up to it. In this regard, there is a useful discussion of the

47. 2 IRBRD 373, 6 IRBRD 115, and 8 IRBRD 189.

48. (1919) 12 TC 92.

49. 2 IRBRD 231.

date of commencement of a property trading business where the facts were quite complex in *D3/86*. In that case, land had originally been acquired for non-trading purposes but was subsequently redeveloped for sale. The Board of Review held that the property development business commenced when an architect was employed to draw up redevelopment plans. The position of a person developing property for letting is, however, likely to be viewed differently and, on the basis of the reasoning in the *Birmingham & District Cattle By-Products* case, such business would probably be viewed as commencing when the property first becomes available for letting.

It should also be noted that evidence of intention at a given date does not necessarily denote commencement at that date; it merely indicates commencement not later than that date. This is of great significance where a property previously held as a fixed asset in a business is redeveloped and then sold.[50]

Although the foregoing paragraphs consider when particular types of business commence, it must be remembered that the investment of money can also constitute a business (see section 2.3.2). Accordingly, if a company is set up which actively invests its share capital and/or shareholder loans, it may be considered to be carrying on a business of investment, even before the principal business which the company was established to operate has commenced. This is important because the carrying on of an investment business will generally render any Hong Kong source interest income subject to Profits Tax (although an exemption from payment of that tax in respect of bank interest may be available), even though only preparatory activities in connection with the principal business are being undertaken.

See section 2.5.13 below for a discussion as to the treatment of pre-commencement expenditure.

■ Example 2.2

Impex Ltd is incorporated on 1 June 2015 for the purpose of carrying on an import and export business. Due to delay in finding suitable office premises the directors actively engage in investing the Company's funds in interest-earning deposits with banks in Hong Kong. On 1 January 2016 office premises are found and staff are employed to establish office routines and set up book-keeping procedures. On 1 March 2016 the first import transaction is entered into and the first profit derived on 15 April.

50. *Overseas Textiles Ltd v CIR* [1987] 3 HKTC 29.

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The trade commences on 1 March 2016 and, in practice the rent and wages for the period 1 January 2016 to 1 March 2016 will be treated as if they were incurred on 1 March 2016 (see section 2.5.13 below).
Also, the Company was carrying on an investment business in the period before it commenced the import/export trade and, therefore, would be subject to Profits Tax on any Hong Kong source interest earned in that period (although payment of the actual tax is not currently required because of an order of the Chief Executive in Council, as discussed in point (16) of section 2.5.3).

2.3.6 Cessation of business

It is also important to be able to establish the date of cessation of business because upon this depends the final basis period (see section 2.6.3). Additionally, it is important because of the special treatment afforded to post-cessation payments and receipts and the treatment of trading stock upon cessation (see sections 2.5.12 and 2.5.14).

Again, the date of cessation is largely a question of fact and it is important to distinguish between the temporary suspension of a trade and its final cessation. This is particularly difficult in the case of property development when the completion of a development does not of itself signify cessation of trade, because there could be a considerable period of inactivity while further suitable property is sought for development. Furthermore, the appointment of a liquidator does not necessarily constitute the cessation of trade; this must be judged on the facts, because a liquidator may continue the trade for a period of time in order to protect the assets. However, if the liquidator is merely realising assets, including trading stock, in order to wind up a company, this is unlikely to constitute the continuation of the company's previous trade.[51] The circumstances could also exist, e.g., in the case of a property developer who sells his last property on an instalment basis and, although he does not seek to acquire or develop any more property, continues to collect the instalments. As it may be appropriate to bring in the profit on sale only in relation to each instalment received,[52] it is quite likely that the business can be said to continue until the final instalment is received. This should be contrasted with the facts in the *Tai Shun Investment Co*[53] case where only a few instalments remained to be collected and the liquidator was held to be merely tidying up.

51. *Tai Shun Investments Co v CIR* [1968] 1 HKTC 370.
52. *CIR v Montana Lands Ltd* [1968] 1 HKTC 334.
53. See footnote 50.

The circumstances in Example 2.2 could equally apply in reverse so that a company could cease trading yet still be in business.

2.4 Source of Profits

As with Salaries Tax, the determination of the source of income for Profits Tax purposes is fundamental in ascertaining whether a liability to the tax exists. This territoriality principle is also embodied in the Property Tax provisions, although in the case of that tax the issue is less complex as it is manifested by levying the tax only on property situated in Hong Kong.

As was noted in section 2.3, under Sec. 14, the general Profits Tax charging provision, a liability to Profits Tax exists only where all of the following conditions are fulfilled:—

(i) the taxpayer carries on a trade, profession or business in Hong Kong;
(ii) the taxpayer derives profits from that trade, profession or business; and
(iii) those profits arise in or are derived from Hong Kong (i.e., are sourced in Hong Kong).

The first of these tests was discussed in section 2.3, while the second is usually (but by no means always) a relatively straightforward question of fact. The final test, the determination of the source of profits, is undoubtedly the test which consistently gives rise to the greatest practical difficulties and is the subject of this section. To fully understand what determines the source of profits, it is necessary to carefully analyse the statutory provisions and the relevant case law, and this is done below. Also discussed below is the Commissioner's DIPN on the matter which provides a practical insight into how the IRD approaches the question of source of profits.

2.4.1 Statutory provisions

Unfortunately, the IRO provides no comprehensive guidance as to how the source of profits is to be determined. Sec. 14, the general charging provision, merely uses the phrase *"profits arising in or derived from Hong Kong."* Sec. 2 defines this phrase for Profits Tax purposes to *"without in any way limiting the meaning of the term, include all profits from business transacted in Hong Kong, whether directly or through an agent."*

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The terms *"arising in"* and *"derived from"* have been held to have identical meanings.[54]

The issue was crystallised in *Harding v FCT*:[55]

> *"I see no difference between income arising from a source and income derived from a source, at any rate for present purposes, and the two interpretations would carry precisely the same meaning for present purposes if the one word were substituted for the other."*

The effect of the Sec. 2 definition of the phrase *"profits arising in or derived from Hong Kong"* has been considered in a number of Hong Kong decisions. The courts have, usually by implication rather than directly, generally been reluctant to read the term as significantly expanding the phrase as used in Sec. 14. For a case where the court specifically stated that the definition did not widen the term, however, see the Court of Appeal judgement in the *Hang Seng Bank* case (above).

It cannot be emphasised too much that the very structure of Sec. 14 pre-supposes that the questions of where a business is carried on and the source of the profits of that business are to be determined independently of each other and are not to be muddled into a single test. Similarly, it is clear that the section envisages that a business carried on in Hong Kong may earn profits which, as a matter of law, arise elsewhere, even though that business does not have a branch elsewhere.

This issue was discussed at some length in the report of the Third Inland Revenue Ordinance Review Committee which ultimately recommended that the law be changed to exclude from Profits Tax only those profits the generation of which was substantially brought about by the activities of a branch of the taxpayer outside Hong Kong. These recommendations were never implemented (except in respect of certain types of income earned by financial institutions). Accordingly, it must be assumed that the Government is satisfied with the scope of the charge imposed by Sec. 14 as currently structured.

54. See *C of T (NSW) v Kirk* [1900] AC 588 at 592, which was quoted with approval in *CIR v The Hong Kong and Whampoa Dock Co Ltd* (1960) 1 HKTC 85 at 98–99, and *CIR v International Wood Products Ltd* (1971) 1 HKTC 551 at 563. Although the Court of Appeal in *CIR v Hang Seng Bank Ltd* (1989) 2 HKTC 614 suggested that "derived from" was a broader term than "arising in," this was subsequently rejected by the Privy Council on appeal, [1991] 1 AC 306, [1990] 3 WLR 1120, (1989) 3 HKTC 351.

55. (1917) 23 CLR 119 at 131.

Nonetheless, despite the fundamental nature of the distinction between the place where a business is carried on and the place where the profits of a business arise, the two appear to have been confused at times by the courts and Board of Review.

2.4.2 Case law — general principles

A term which is frequently encountered when dealing with the ascertainment of the source of profits is the "operations test." Unfortunately, although the origins of this test are clear, it has been applied in different ways in various cases and, as a result, the term has come to mean slightly different things to different people. Consequently, care needs to be taken when using the term.

The "operations test" stems from the words of Lord Atkin in *Smidth & Co v Greenwood*[56] where he said

> *"... the question is, where do the operations take place from which the profits in substance arise?"*

Whilst this may well be an appropriate general test for determining the source of profits, it is somewhat ironic that the *Smidth v Greenwood* case involved the interpretation of UK legislation and, in particular, the question of where the taxpayer's trade was exercised. This issue was relevant because, under the UK legislation at the time, a person's profits were taxable in the UK if they arose from a trade exercised in the UK, irrespective of the legal source of those profits. In other words, the case was not about source of profits at all; if it had any direct relevance to the IRO, it is arguably more likely to be with regard to the question of where a person's trade, profession or business is carried on. In this regard, although, as we shall see, the questions of where a business is carried on and the source of profits have been confused at times, it is worth emphasising again that the structure of Sec. 14 makes it clear that the two questions are to be considered independently.

Notwithstanding the fact that the statutory test being considered in the *Smidth v Greenwood* was not one of source of profits, the "operations test" as formulated by Lord Atkin has been adopted as a test (indeed, on a high level, as *the* test) for source of profits. Indeed, in *CIR v Lever Brothers & Unilever Ltd*, which was a source case, Watermeyer CJ introduced the somewhat similar, although perhaps slightly broader, concept of

56. [1921] 3 KB 538.

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go over to the non-pooling system after a period of time on the pooling system (see Example 3.9). In this situation, a balancing allowance cannot arise.

A balancing charge and/or a balancing allowance may arise when a person ceases to carry on a trade, profession or business. At the end of the basis period in which the cessation takes place, the reducing value of each class of plant and machinery is reduced by the sale, insurance, salvage or compensation proceeds from the relevant assets. If there is a positive balance, this becomes a balancing allowance. If there is a negative balance, this becomes a balancing charge (Sec. 39D(2)). However, in arriving at a balancing charge, the amount of sale, etc. proceeds deducted must not exceed the original qualifying expenditure in respect of the plant or machinery which was brought into the class (Secs. 39D(6) and 39D(7)).

Where there are no sale, etc. proceeds as a result of another person succeeding to the business by way of gift or on death of the owner, there is no balancing allowance or charge (Sec. 39D(3)). The successor inherits the reducing value (see section 3.8.2).

The IRD published a non-binding assessing guidance on its website and also shared its view during its meeting dated 11 March 2016 with HKICPA on various tax issues relating to court-free amalgamations (including the treatment of depreciation allowances). If the court-free amalgamation is structured with a sale of assets on an arm's length basis, the IRD considers that the provisions relating to sale of assets will be applied to such amalgamation to assess any deemed trading receipts and to make balancing adjustments. On the other hand, a "succession" approach is applicable to the capital assets succeeded from the amalgamating companies, where the amalgamated company would qualify to claim annual depreciation allowances, which should be based on the reducing value of the plant or machinery succeeded, without any balancing charge or balancing allowance.

Where, however, there are no sale, etc. proceeds and there is no succession to the business by another person, the IRD will estimate the open market value of the plant and machinery and deduct this from the relevant class as if it had been sale etc. proceeds received immediately prior to cessation. The balance of each class then becomes the subject of a balancing allowance or charge (Sec. 39D(4)). However, if there is an actual sale within 12 months of the date of cessation, the taxpayer can claim an adjustment to the balancing allowance or charge by substituting the sale price for the estimated open market value previously adopted and

the assessment is adjusted, even if it had become final and conclusive (Sec. 39D(5)). This provision appears to suggest that if plant and machinery is scrapped on cessation of business and no proceeds received, for the purpose of calculating balancing charges and allowances, there is a deemed sale at market value. However, if plant and machinery is scrapped in these circumstances it would usually be because the assets had no significant open market value; in other words, if the assets had an open market value, they would probably not have been scrapped. This is probably one reason why the provision appears to have only limited application in practice. Another reason is that, because of the usual delay between the cessation of business and the filing of the return, the actual proceeds of any sale are known at the time of filing the return and, therefore, an estimate is not required.

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■ Example 3.8

The facts are as in Example 5.7. In the year ended 31 December 2013, there are no purchases of fixed assets and a photocopier is sold for $20,000, having cost $25,000 some years ago. On 10 April 2014, all of the remaining assets except the lift were sold and the business ceased. Sales proceeds were:—

Motor Vehicles	$ 40,000
Air Conditioning	$100,000
Office Equipment etc.	$ 5,000

The lift which had an estimated open market value of $60,000 in April 2014 was sold in December 2014 for $50,000.

Depreciation Allowances are:—

	30% Pool	20% Pool	10% Pool	Allowances
Reducing Value brought forward	$77,327	$19,634	$117,746	
2013/14				
Disposal		20,000		
		($ 366)		
Balancing Charge		366		($ 366)
		Nil		
Annual Allowance	23,198		11,775	34,973
				$34,607
Reducing Value	$54,129	Nil	$105,971	
2014/15 (Final)				
Sales	40,000	5,000	100,000	
	$14,129	($ 5,000)	$ 5,971	
Market Value of Lifts			60,000	
			($ 54,029)	
Balancing Charges		5,000	54,029	($59,029)
Balancing Allowance	14,129			14,129
				($44,900)

Notes:—

(a) The 2014/15 assessment being the cessation year is initially settled with a balancing charge of $44,900. When the lifts are sold in December 2014, Puh Ling Ltd. can claim to adjust the assessment, even if it is final and conclusive, by amending the balancing charge to $34,900 because of the substitution of sale proceeds of $50,000 for the estimated market value of $60,000.

(b) This example assumes that allowances remain the same up to 2014/15.

■ Example 3.9

The facts are the same as in Example 3.7 except that on 1 March 2013, the nature of the business changed so that the assets were only used 75% for earning assessable profits. The estimated market values of the plant and machinery at that date were:—

Motor Vehicles	$ 70,000
Office Equipment, etc.	$ 30,000
Air Conditioning and Lifts	$150,000

As the change takes place during the basis period for 2013/14, the annual allowances for that year are computed on the non-pooling method starting with the open market values as if they were the amounts of unrelieved expenditure brought forward.

The calculations would proceed as follows:—

2013/14	30% Pool	20% Pool	10% Pool	Allowances
Reducing Value brought forward	$77,327	$19,634	$117,746	
Market Values	70,000	30,000	150,000	
Reducing Value	$ 7,327 (b)	($10,366)	($ 32,254)	
Balancing Charge		10,366	32,254	($42,620)
	Motors Vehicles 30%	Office Machinery 20%	Lifts and Air Conditioning 10%	
Expenditure per Sec. 39C(3)	$70,000	$30,000	$150,000	
Annual Allowance	21,000	6,000	15,000	$31,500 (75%)
Written Down Value at 1.1.2014	$49,000	$24,000	$135,000	($11,120)

Notes:—

(a) No initial allowance arises in respect of the transfer from the pools to the non-pooling system because no expenditure has been incurred in the basis period. Sec. 39C(3) only deems the reducing value of the expenditure to be equal to the market value figures.

(b) There is no provision for a balancing allowance in these circumstances. It is not clear whether annual allowances continue to be claimable on this amount of $7,327 and, if so, whether they have to be apportioned according to non-assessable use. If the latter is correct it would of course defeat the point of transferring the expenditure of $70,000 to a computation on the non-pooling system.

3.9 Plant and Machinery Allowances (Non-Pooling System)

The arithmetically cumbersome non-pooling system applied in all cases up to and including 1979/80; since 1980/81, however, it has only applied where the pooling system (see section 3.8) is specifically not to be applied. There are, therefore, specific circumstances (see section 3.7) where the non-pooling system may still apply in respect of one asset, a group of assets or, indeed, all assets of the business. The fundamental difference is that, whereas under the pooling system assets are grouped into classes or pools which expand or contract upon acquisitions and disposals without, in general, the necessity to calculate balancing allowances and charges, under the non-pooling system calculations have to be made for each individual asset with balancing adjustments on disposal in each case.

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3.9.1 Initial allowance

An initial allowance is given for the year of assessment relating to the basis period in which the expenditure is incurred (Sec. 37(1)). The current rate of this allowance is 60% of the qualifying expenditure. It is not necessary for the asset to be brought into use in the basis period. It is sufficient that the expenditure is incurred while a trade, profession or business is carried on. Where a person succeeds to a trade, profession or business and the assets used for that business are acquired other than by way of purchase, he can, as will be seen, claim annual allowances notwithstanding having incurred no expenditure. He cannot, however, claim an initial allowance (Sec. 37(5)).

Where the plant or machinery is acquired under a hire-purchase agreement, the initial allowance is spread over the period during which instalments are paid. The relief is given on the instalments paid in each basis period and is only given on the capital element of the instalments (Secs. 37A(1) and 37A(1A)). The revenue element, being interest, would normally qualify as a deductible expense in the period in which it was incurred. This is illustrated in Example 3.10.

■ Example 3.10

Nevanevva Ltd. has entered into a hire-purchase agreement on 1 June 2011 to acquire some hydrofoils for its Hong Kong shipping business. The cash price of the hydrofoils was $24,000,000 and the Company agreed to pay $31,200,000 by 24

monthly instalments commencing 1 June 2011. The Company's accounting date is 31 December.

The instalments are $1,300,000 per month
The capital element is $1,000,000 per month

Initial Allowance — 2011/12	— Instalments to 31.12.2011	$ 7,000,000
	— Initial Allowance (60%)	$ 4,200,000
— 2012/13	— Instalments in year to 31.12.2012	$12,000,000
	— Initial Allowance (60%)	$ 7,200,000
— 2013/14	— Instalments in period to 31.12.2013	$ 5,000,000
	— Initial Allowance (60%)	$ 3,000,000

The interest element of $300,000 per month would be allowed as a revenue expense in the three years of assessment.

Notes:—

(a) The calculation is not included with other assets in calculations under the pooling system because assets being acquired by hire purchase are specifically excluded from the pooling system because of the obvious necessity to make an individual calculation (Secs. 39C(1)(a) and 39C(2)). It is transferred to the pooling system when the option to purchase is exercised (see Example 3.12).

(b) The meaning of hire-purchase is defined in Sec. 40(1) which has adopted the common law definition (see section 3.10.1).

3.9.2 Annual allowance

An annual allowance is available where, at the end of a basis period for a year of assessment, a person owns and has in use machinery or plant for the purposes of producing profits assessable to Profits Tax (Sec. 37(2)). Note that the two important criteria of "ownership" and "in use" do not apply for an initial allowance. Accordingly, an initial allowance can be claimed on a capital contribution in respect of an asset owned by another person, provided that the claimant has the use of the asset, but no annual allowances are available. Also, where an asset is acquired but not brought into use for a period of time, the initial allowance is available at the outset but the annual allowances are deferred.

The annual allowances for each basis period are computed on the amount of the qualifying expenditure less:—

(1) the initial allowance given on that expenditure; and
(2) previous annual allowances given.

There are also two situations where notional annual allowances must be deducted in arriving at the net expenditure upon which annual allowances are to be given. These are:—

(1) where an asset was used by the owner for other purposes prior to bringing it into use for the purpose of producing profits chargeable to Profits Tax, notional annual allowances must be deducted as if such allowances had been available since the owner's acquisition of the asset (Sec. 37(2A)); and

(2) in the taxation of shipping operations where because a ship ceases to be on the Hong Kong Register of Shipping, it may commence to give rise to assessable income. In these circumstances, Sec. 23B(8) provides that depreciation allowances are to be calculated on the reducing value after deducting any initial allowance given and notional annual allowances (see section 2.7.3).

There is no single rate of annual allowance prescribed by the IRO. The rates are to be as prescribed by the Board of Inland Revenue (Sec. 37(2)). The prescribed rates are laid down in Rule 2 of the IRR and the table is contained in DIPN 7. The Commissioner is empowered by Sec. 37(2) proviso (b) to allow a higher rate of annual allowance in appropriate circumstances. In paragraph 47 of DIPN 7, the IRD set out the information which it would require in order to consider any such claim for increased allowance rates. Nonetheless, in paragraph 48 of that document, the IRD goes on to say that given the current rates of allowances, it is unlikely that any claim for increased rates could be justified.

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■ Example 3.11

Ben Dover has an earth moving business in Hong Kong and in his accounting year ended 31 December 2011, he bought a new bulldozer for $2,800,000. The machine required special modifications, however, and he was unable to bring the machine into use until July 2013. He also brought into his Hong Kong business in December 2011 a grader which he had bought in 2009 for $2,000,000 and which had been in use in his Taiwan business. Of his Hong Kong profits, 10% is not assessable to Profits Tax.

Extracts from Ben's depreciation allowance schedules are as follows:—

	Bulldozer (30%)	Grader (30%)	Other Plant & Machinery (20%)	Total
Written Down Value at 1.1.2011			$630,000	
2011/12				
Acquisition in year	$2,800,000	$980,000 (b)		
Initial Allowance (60%)	1,680,000	—	—	$1,680,000
	$1,120,000			
Annual Allowance	—	294,000	126,000	420,000
				$2,100,000 (d)

not (Sec. 38(1)(a));

(2) where the machinery or plant is destroyed (Sec. 38(1)(b)); or

(3) where the machinery or plant is permanently put out of use (Sec. 38(1)(c)).

Where one of these events takes place while the person is carrying on a trade, profession or business or is coincident with his ceasing of that trade, profession or business, an allowance or charge is computed and is allowed or assessed for the year of assessment in the basis period for which the event occurs.

Where the sales proceeds or other receipts upon disposal such as insurance or salvage receipts are either nil or are less than the unrelieved qualifying expenditure, the result is a balancing allowance equal to the difference. Where the receipts exceed the unrelieved qualifying expenditure, the result is course a balancing charge equal to the difference. In the case where the starting cost is ascertained under Sec. 37(2A) in respect of an asset being used for other purposes before being brought into use to produce profits assessable to Profits Tax, the ascertained starting cost rather than the actual original cost represents the qualifying expenditure for the purpose of the allowance or charge. Also, where annual allowances have been given to a successor to a business, other than by purchase, under Sec. 37(4), the inherited written down value is the qualifying expenditure for the purpose of the allowance or charge (Sec. 38(2)).

Where a person ceases to carry on a trade profession or business and a balancing allowance or charge arises as a result of plant or machinery being put out of use, the disposal receipts to be brought into account is the open market value which the IRD considers should be attached to the machinery or plant as at the date of cessation. If, however, the plant or machinery is sold within 12 months of the date of cessation, the taxpayer may claim to adjust the allowance or charge to the figure which would have been computed if the actual sale proceeds were substituted for the open market value. If the result necessitates a reduction to an assessment which has become final and conclusive, the assessor must make the reduction notwithstanding the provisions to the contrary in Sec. 70 (Sec. 38(4)).

A balancing charge must do no more than recover an initial allowance and annual allowances actually given; it is not a tax on a capital profit (Sec. 38(5)). In cases where the amount on which allowances were first calculated is lower than the original cost, the lower figure is treated as the original qualifying expenditure for balancing charge purposes.

■ Example 3.13

Artie Vee inherited a printing business from his deceased father's estate together with the printing machine which had cost his father in excess of $1 million. At the date of his father's death, the written down value of the machine was $250,000. Artie used the machine in the business for two years, receiving annual allowances as follows:—

Inherited Cost (Sec. 37(4))	$250,000	
Annual Allowance Year 1 (20%)	50,000	$50,000
	$200,000	
Annual Allowance Year 2 (20%)	40,000	40,000
Written Down Value	$160,000	$90,000

He then sold the machine for $300,000.
His balancing charge is:—

Sale proceeds	$300,000	
Unrelieved qualifying expenditure	160,000	
	$140,000	
However, it is restricted to actual allowances granted		$90,000

No part of the allowances claimed by his father can be recovered by the balancing charge. Had his father lived and continued the business, his balancing charge would have been $140,000.

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Where a balancing charge arises in respect of the disposal of plant or machinery and that plant or machinery is replaced, tax on the balancing charge can be deferred by making an election to reduce the qualifying expenditure on the replacement asset and thereby reduce future initial and annual allowances (Sec. 39). The election must be made in writing. Although no time limit for the election is given, this would have to be before an assessment incorporating the balancing charge becomes final and conclusive because there is no specific authority to re-open an assessment to admit the election. It is unlikely that failure to make an election could be construed as an error or mistake for the purposes of Sec. 70A (see Chapter 8).

The election is effected as follows:—

(1) Where the balancing charge exceeds the qualifying expenditure on the replacement asset, the following consequences arise:—

(i) the balancing charge is restricted to the difference between the original balancing charge and the replacement expenditure;

(ii) no initial or annual allowances can be given on the replacement expenditure because it effectively becomes nil; and

(iii) when a balancing charge comes to be made on a disposal of

the replacement asset, the amount of such charge is the smaller of the sales proceeds or the amount of the replacement expenditure.

■ Example 3.14

Assume in the facts in Example 3.13 that Artie had been able to buy another printing machine for $50,000.

If he made the election under Sec. 39, the following consequences would ensue:—

(1) His balancing charge would be restricted to $90,000 – $50,000 = $40,000.
(2) He could claim no initial or annual allowances on the replacement machine.
(3) If in due course he disposes of the replacement machine for, say, $30,000, he would have a balancing charge of $30,000. If he disposed of it for, say $60,000, he would have a balancing charge of $50,000. In either case he could, of course, again elect under Sec. 39 if he replaced the machine.

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(2) Where the balancing charge is less than the qualifying expenditure on the replacement asset, the following consequences arise:—
 (i) the balancing charge is completely eliminated;
 (ii) the initial allowance and annual allowances on the replacement asset are to be given on expenditure equal to the difference between the actual qualifying expenditure and the eliminated balancing charge; and
 (iii) in computing the balancing allowance or charge on disposal of the replacement asset, the initial allowance under (ii) is deemed to have been increased by the amount of the eliminated balancing charge.

■ Example 3.15

Assume in the facts in Example 5.13 that Artie had bought a replacement printing machine for $150,000.

If he made the election under Sec. 39, the consequences would be:—

(1) His balancing charge would be reduced to nil;
(2) Allowances on the replacement asset would proceed as follows:—

Cost	$150,000
Less: Balancing Charge	90,000
	$ 60,000
Initial Allowance (60%)	36,000
	$ 24,000
Annual Allowance (20%)	4,800
Written Down Value	$ 19,200

(3) If the machine is then sold for, say $70,000, the balancing charge calculation proceeds as follows:—

Sale Proceeds	$70,000
Written Down Value	19,200
Balancing Charge	$50,800

Notes:—
(a) Ordinarily, the balancing charge would be limited to the allowances actually given, namely $40,800, but as the balancing charge of $90,000 which has been set off is deemed to be an initial allowance, the maximum balancing charge on disposal of the replacement is $130,800 and therefore the above calculation is correct.
(b) Artie could of course again elect under Sec. 39 if he replaced it again.

3.10 Leasing

In order to curb a perceived loss of revenue in connection with sale and leaseback of secondhand plant and machinery and certain leverage lease arrangements, some complicated provisions (Sec. 39E) were introduced to deny initial and annual allowances to a lessor of plant and machinery in certain of the following situations:—

(1) Plant and machinery is purchased from and leased back to the same person or an associate of that person ("sale and leaseback").
(2) Certain leveraged leases involving ships or aircraft.
(3) Certain leveraged leases involving other plant and machinery used wholly or principally outside Hong Kong, or financed wholly or predominantly by non-recourse debt.

The provisions affect only initial and annual allowances otherwise claimable by the lessor. There are no other tax effects, although the provisions attempt to make clear what is a lease as distinct from a deferred purchase of an asset. The provisions do not, however, in any way address the issue of the assessability of lease rentals.

It should, however, be noted that previously in DIPN 21, the Commissioner has stated that where Sec. 39E operates to deny a lessor depreciation allowances in respect of leased plant and machinery that is used wholly or principally outside Hong Kong, the income from the leasing of that plant and machinery will generally be regarded as non-taxable. This practice is now contained in paragraph 17, Example 3 of DIPN 15.

The provisions affecting ships and aircraft apply to leases predominantly financed by way of non-recourse debt and also to cross border leases where the lessee in not a "Hong Kong operator" of ships or aircraft.

3.10.1 When is a lease not a lease?

It is important to be able to ascertain when an arrangement constitutes a

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lease and when it does not. This is because, generally, the entire periodic payments under a lease are rentals which are, subject to the usual profits tax provisions, fully assessable to the lessor and fully deductible to the lessee. Where, however, an arrangement is not a lease but some form of purchase arrangement, the periodic payments will normally be partly interest and partly capital.

In deciding whether an arrangement is to be considered a lease, it is appropriate in the first instance to consider the definition of "lease" in Sec. 2. This definition excludes from the meaning of a lease a hire-purchase agreement and a conditional sale agreement, unless the Commissioner is of the opinion that the right under such an agreement to purchase or obtain the property in the goods would reasonably be expected not to be exercised. The terms "hire-purchase agreement" and "conditional sale agreement" are themselves defined as follows:—

(1) **Hire-Purchase Agreement:** This follows the common law definition in referring to an agreement for the bailment (hire) of goods under which the bailee (hirer) may buy the goods or under which the property in the goods will or may pass to the bailee (Sec. 2). This seems to cover the situation where there is an opportunity to acquire the asset even at a full market value. The right or opportunity must, however, be under the agreement although a side letter with no separate consideration may well be part of the agreement.

The above definition does not extend to the situation where an associate of the hirer may purchase or otherwise obtain the goods. Nonetheless, in DIPN 15, the IRD expresses the view that such an arrangement is unacceptable, which presumably means that they consider that they can challenge an arrangement where a person seeks to avoid the definition of a hire-purchase agreement (and therefore potentially fall within the definition of a lease), by arranging for an associate to acquire the right to purchase or obtain title to the goods.

In addition to being relevant to the definition of a lease, the statutory definition of a hire-purchase agreement is also relevant for the purpose of Sec. 37A which sets out rules for claiming depreciation allowances in respect of goods acquired under a hire-purchase agreement, as was discussed in sections 3.9.1 and 3.9.2.

(2) **Conditional Sale Agreement:** This is defined in Sec. 2 and means a sale agreement where the consideration is payable by instalments but ownership remains with the seller until the conditions laid down in the agreement as to payment of instalments or otherwise, are satisfied.

It is also appropriate to note that the definition of a lease in Sec. 2 extends to arrangements that do not amount to a formal lease but under which the owner of plant and machinery grants a right to use that plant and machinery to another person. Successive grants to other persons are also recognised as a lease.

Although the term "lease" is statutorily defined, the IRD in DIPN 15 provides further factors which it considers need to be satisfied for an arrangement to be accepted as a lease. In particular, the IRD states that a lease or any related documentation cannot contain any provision under which the ownership of the goods may pass to the lessee. This requirement effectively already exists through the exclusion of hire-purchase and conditional sale agreements from the statutory definition of a lease. Additionally, however, the IRD states that an arrangement will not be considered a lease unless the residual value provided for in the lease is reasonable. This requirement has no statutory basis, however, and for the IRD to challenge an arrangement on this basis would presumably require the application of Sec. 61 or 61A (see Chapter 10).

Notwithstanding the reasonably extensive definition of "lease" in Sec. 2, the application of that definition in other statutory provisions raises some uncertainties. This is because the term is not used to specify the normal treatment of lease rentals, but is relevant only for a limited number of specific provisions. For example, it is relevant for the purpose of Sec. 39E (an anti-avoidance provision discussed in sections 3.10.2 and 3.10.3). However, because the statutory definition excludes hire-purchase and conditional sale agreements, the lessor or seller under such arrangements cannot be denied depreciation deductions pursuant to Sec. 39E. It is not clear whether this is because the legislature intended that the lessor or seller claim the depreciation allowances in such circumstances or because the allowances are not considered available to that party anyway.

In the case of a hire purchase agreement, the lessee (buyer) can certainly claim allowances under Sec. 37A, but there is nothing in the IRO which says that the lessor (seller) cannot also claim them on the grounds that he is still the owner and he may regard the instalments as lease rental income. Sec. 39E does nothing to change this because it does not apply to hire purchase arrangements. The lessee (buyer) cannot, of course, claim both the depreciation allowances and the instalments as lease rental payments, but does he have an option?

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Reference to case law may decide the issue. In particular, *Littlewoods Mail Order Stores Ltd. v McGregor*[26] is relevant. In that case, a company surrendered an 88-year lease on a building for a 22-year lease at a materially higher rent as part of a transaction in which a subsidiary of the company acquired the freehold. The additional rent paid was disallowed as being capital expenditure in acquiring an asset, namely the freehold, notwithstanding that the asset was acquired by a subsidiary. DIPN 15 (paragraphs 63 to 66) indicate that this may be the IRD's view as applied to a hire-purchase agreement, thereby ensuring that the lessee (buyer) has no option but to claim depreciation allowances. The lessor (seller) would, in the same light and depending upon his circumstances, probably be treated as either a dealer in the goods which are the subject of the agreement or having, in effect, made a loan. Either way it would be unlikely to be treated as a lease.

There must, however, be a strong doubt as to whether the principle established in the *Littlewoods* case could apply where there is a lease at a normal market rent with an option to purchase at any time at the market value at that time. Such an agreement would fall into the definition of hire purchase agreement in Sec. 40(1) but the rental payments lack the hallmarks of a hidden purchase element. In those circumstances it would seem open to the lessee to claim the rentals as a deduction and for the lessor to claim depreciation allowances and yet not be subject to the restrictions in Sec. 39E.

In the case of a conditional sale agreement, there can never be any question of treating the instalments as rental payments either in the hands of the buyer or the seller, because the agreement is quite simply a sale and not a hire arrangement. It is, therefore, not surprising that it is excluded from the application of Sec. 39E because, fundamentally, it can never be a lease. The buyer can claim initial allowances on the instalments as they become due but cannot claim the annual allowances until such time as the agreement becomes unconditional and he becomes the owner. There is, however, no good reason why a purchaser under a conditional sale agreement should not have the same entitlement to annual allowances from the outset as a purchaser under a hire-purchase agreement but Sec. 37A does not presently permit this.

3.10.2 Sale and leaseback

Initial and annual allowances are denied to a lessor of plant and machinery

26. (1959) 45 TC 519.

where, prior to acquisition by the lessor, the plant and machinery had been owned and used by the person who is now the lessee or part lessee with others or by any person associated with the lessee (Sec. 39E(1)(a)). Because this is an anti-avoidance provision, various terms used in this connection are widely defined in Sec. 39E(5). For example an "associate" is very widely defined to include all kinds of connected persons and companies under common control as follows:—

(a) Where the lessee is a natural person:—
- a relative.
- a partner or any relative of a partner.
- a partnership of which he is a partner.
- a company controlled by the lessee or by his partner or a partnership of which he is a partner or a director or principal officer of any such company.

(b) Where the lessee is a company:—
- a company which it controls or is controlled by it or is under the same control directly or indirectly as the lessee company.
- a person who controls the company and any partner or relative of such person.
- a director or principal officer of the lessee company or of any company under common control with it as above and any relative of such director or officer.
- a partner of the lessee company or any relative of such partner.

(c) Where the lessee is a partnership:—
- a partner and, where a partner is itself a partnership, any partner of that partnership.
- a partner with the lessee partnership in any other partnership and, where such a partner is itself a partnership, any partner of that partnership.
- where any of the partners included in the above provisions is a natural person, any relative of that partner.
- a company controlled by the lessee partnership or by any partner or relative of a partner or any director or principal officer of such company.
- a company of which a partner is director or principal officer.

"Control" is further defined widely to mean any power exercisable by the holding of shares or voting power or any other power contained in the articles of association or other document regulating the affairs of a company. Both "relative" and "principal officer" are also widely defined.

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Once it has been identified that the lessor has purchased the relevant asset from the lessee or an associated person, it is necessary to see whether the lessee or associated person owned and used the plant and machinery in question. It is often the case that the lessee may have initially contracted with a supplier for the equipment but, before delivery, sold the benefit of the purchase agreement to a financier who will become the lessor. If these arrangements are such that the lessor obtains title directly from the supplier, there is no question of denial of depreciation allowances to the lessor under Sec. 39E(1)(a). Even if title does pass from the supplier to the lessee and then to the lessor, there is still no question of the application of Sec. 39E(1)(a) unless the lessee actually used the equipment before reselling it to the lessor. Whether the equipment has been used is a question of fact but it is defined in Sec. 39E(5) to include equipment which is installed ready for use and held in reserve.

The law does, however, recognise the realistic position that, due to a temporary delay in financing arrangements, equipment may for a short period actually be in the ownership and use of the lessee. The lessor will still be entitled to the initial and annual allowances provided that:—

(a) the lessor's purchase price paid to the lessee or lessee's associate was not more than the price which the lessee or associate paid to the supplier. This relaxation is not available if the supplier or his associate was in fact an owner and user of the equipment. This provision prevents the use of an intermediate between the original supplier and the lessee to increase the cost which can be passed on to the lessor (Sec. 39E(2)(a)); and

(b) no initial or annual allowances have been granted to the lessee in respect of his initial acquisition of the equipment (Sec. 39E(2)(b)). Because mere acquisition by the lessee will result in at least initial allowances being available to him it is provided that, to enable the relaxation to be effective, he may disclaim any allowances by notice in writing to the Commissioner within 3 months of his initial acquisition of the equipment or such longer time as the Commissioner may permit (Sec. 39E(3)).

Throughout these provisions, when reference is made to an acquisition of plant and machinery, whether by the lessor or the lessee or any associate, this means not only where he becomes the legal owner but also includes holding under the benefit of a hire-purchase or conditional sale agreement (the meanings of which are discussed in section 3.10.1). Without such a provision, until the exercise of the option or the contingency under such

agreements, the "hirer" is in legal terms not the owner (Sec. 39E(5)).

Also, to further tighten the provisions, plant and machinery either owned or leased by a trustee or by a company controlled by such trustee is treated as owned or leased, as appropriate, additionally by the beneficiary of the trust or the company or, in the case of a discretionary trust, by any such beneficiary as the Commissioner may, in his discretion, decide (Sec. 39E(4)). For this purpose, a beneficiary may include an indirect beneficiary through another person or who may be able, directly or indirectly to control the activities of the trust or the application of its income or capital (Sec. 39E(5)).

The provisions of Sec. 39E are also discussed in DIPN 15.

■ Example 3.16

Bremridge Ltd. has contracted with a Japanese shipbuilder for the supply of a passenger ferry at a cost of $20 million. When the ship was ready for delivery, Bremridge Ltd. found that, upon negotiating with financiers, there was a considerable reduction in the cost of financing if it sold the ship to the financier and leased it back over a period of 15 years. The negotiations took a little time, however, and Bremridge Ltd. has taken delivery of the ship and it had been on standby ready for immediate service, although it was not actually put into service, for one month before it was sold to the Hong Kong Taxsavers Leasing Partnership and leased back.

Two questions would arise on this:—

(1) Whether Bremridge Ltd., assuming that it was using the ship for the purposes of earning assessable profits in Hong Kong, could deduct the lease payments.
(2) Whether Taxsavers, also assuming that it was carrying on business in Hong Kong and the lease income represents Hong Kong source income, is entitled to initial and annual allowances on the ship.

Question (1): It would be necessary to check whether the payments constituted lease rentals. If Bremridge has any option or opportunity to purchase the ship at the end of the lease or at any earlier time this would amount to a hire-purchase agreement (see section 3.10.1) and Bremridge could therefore probably only claim the interest element of the payments, assuming that they qualify for relief under Sec. 16(2) (see section 2.5.9). It would also be entitled to depreciation allowances as a hire purchaser. If, however, the purchase option was at a full market value, although this would still amount to a hire purchase agreement for depreciation allowance purposes, Bremridge may well be able to claim the instalments as lease rentals instead of depreciation allowances (see discussion in section 3.10.1).

Question (2): First of all if question (1) determined the lease to be a hire-purchase arrangement, Taxsavers could obtain no depreciation allowances because its expenditure on the initial purchase from Bremridge would probably not be regarded as capital expenditure in view of the immediate resale back to Bremridge. So far as Taxsavers is concerned it is therefore probably treated as a financing transaction

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with the income to Taxsavers being the interest element of the payments and no entitlement to depreciation allowances.

If, however, the leaseback was accepted as constituting a lease, Sec. 39E(1)(a) would operate initially to deny initial and annual allowances to Taxsavers because Bremridge had owned and used the ship before selling it to Taxsavers. Keeping it on standby amounts to it being used for this purpose.

Taxsavers is, however, protected by Sec. 39E(2) provided that:—

(a) It pays Bremridge not more than $20 million for the ship; and
(b) Bremridge writes to the Commissioner within 3 months of the conclusion of its contract with the shipbuilder, disclaiming any depreciation allowances. If, as is often the case in the purchase of substantial assets such as ships, the purchase contract had been concluded long ago, the Commissioner may permit an extension to the period of disclaimer. If, however, Bremridge had claimed initial allowance on progress payments it is not clear whether these could be disclaimed and reversed.

Notes:—

(a) Even though Taxsavers may have eventually passed the tests under Secs. 39E(1) and 39E(2), it will also have to pass the leveraged lease tests relating to ships (see next paragraphs) and, having passed those, the general anti-aviodance tests in Sec. 61A (see section 11.4.5) before it can be certain of obtaining the allowances.
(b) The assumptions have been simplified for the purpose of illustration. Even so, the complexity and inter-relationship of numerous taxation principles should demonstrate to the reader the severe complexity that anti-avoidance legislation injects into a commercial transaction.
(c) See also DIPN 15 for the IRD's view on these issues.

3.10.3 Leveraged leases — general

The type of leveraged lease which has attracted adverse attention is, in very broad terms, one whereby the lessor finances his acquisition of the plant and machinery substantially by way of loan finance where the lender has recourse only to the asset itself or the income arising from the leasing of the asset and, furthermore, where the lessee's use of the asset does not give significant economic benefit to Hong Kong. The reason why these factors have attracted attention is that a lease of a substantial piece of plant or machinery, such as an aircraft, could be structured whereby the lessor is a Hong Kong registered limited partnership carrying on business in Hong Kong and the lessee may use the equipment wholly outside Hong Kong. The lease could be concluded so that the profit therefrom has a Hong Kong source and, therefore, substantial losses for Profits Tax purposes could arise in the early years due to the high depreciation allowances (especially the initial allowance of 60%) and a high interest charge. As a consequence, limited partners with taxable profits in Hong Kong

could reduce those profits by their shares of the losses and yet not be at risk because the lender has no recourse to their assets.

The anti-avoidance provisions strike at these apparent benefits in two ways. Firstly, in Sec. 39E, by denies depreciation allowances to the lessor where identified tests are not met. Secondly, in Sec. 22B, by prevents the limited partners from using their shares of partnership losses against other income. Even if the tests in Secs. 39E and 22B are satisfied, the arrangements may still be considered by the Commissioner in the light of the general anti-avoidance provisions in Sec. 61A (see section 11.4.5). The requirements of Sec. 39E are considered in appropriate circumstances in the following sections and those of Sec. 22B in section 2.5.15.5.

Finally, for the purposes of the provisions relating to leveraged leases as described in the following paragraphs, a lease is as discussed in section 3.10.1. A lease does not include hire-purchase or conditional sale agreements unless the Commissioner considers that the option to purchase is, in all the circumstances, unlikely to be exercised (Sec. 39E(5)).

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3.10.4 Non-recourse debt

What constitutes a "non-recourse debt" in the case of a lease is very important in determining what is a leveraged lease affected by Sec. 39E.

Sec. 39E(5) defines a non-recourse debt as one where the rights of the creditor in the event of any default in the repayment of the principal or payment of the interest are wholly or predominantly limited to no more than:—

(a) rights against the equipment itself or its use;
(b) rights against goods or services provided or produced by the use of the equipment;
(c) rights in relation to any loss or disposal of the equipment in whole or in part, e.g. sale proceeds or insurance recovery;
(d) rights against any money payable in connection with (a), (b) or (c) or any conjunction of rights under (a), (b) and (c);
(e) rights in respect of any mortgage or security over the equipment; or
(f) rights related to the financial obligations of the lessee towards the lessor in connection with the equipment, e.g. recourse against the lease rentals.

Even if the rights of the creditor are not specifically limited to all or any of the foregoing rights, the debt will be treated as a non-recourse debt if, in the Commissioner's opinion, the rights can be effectively so limited because the extent of the lessor's assets or the effect of any arrangements to which the lessor is a party, have the result that the creditor's rights are

in effect no more than those listed. For example, where the lessor comprises a limited partnership whose only asset is the equipment in question and the general partners have no material assets, a lender to the partnership would effectively have no more rights than those listed and so any debt would be within the definition of non-recourse debt. Even where the lessor has assets other than the equipment in question, if those other assets are not available to discharge the whole of the debt, including outstanding interest, on the equipment in question, they are to be ignored for the foregoing purposes. Furthermore, if there are other assets but they are pledged as security for another debt, they are also to be ignored for these purposes. The definition cannot, therefore, be circumvented by having more than one asset in a partnership or company if each is secured against debt.

3.10.5 Leveraged leases — ships or aircraft

Initial and annual allowances are denied to a lessor of ships or aircraft or any part thereof, such as an engine, if:—

(a) the lessee is not an operator of a Hong Kong ship or aircraft; or
(b) the whole or a predominant part of the cost of acquisition or construction of the ship or aircraft was financed directly or indirectly by non-recourse debt (see section 3.10.4) (Sec. 39E(1)(c)).

The purpose of this provision is essentially to restrict Hong Kong leveraged leasing transactions to ships and aircraft of Hong Kong based businesses. Without such a restriction, it would be possible to structure leveraged lease transactions in a manner whereby the benefit of tax depreciation allowances on ships and aircraft which had only limited connection to Hong Kong could be enjoyed by Hong Kong taxpayers. Notwithstanding that this would also require the income from the leasing of such assets to be brought into the charge to Hong Kong Profits Tax, the generous nature of the depreciation allowances and the typical rental stream flows under such transactions could potentially result in significant revenue losses to the IRD in either absolute, or net present value, terms.

For the purpose of paragraph (b) in the above definition, the Commissioner, in DIPN 15 considers, quite logically, that finance will only be considered predominantly non-recourse where at least 51% of such finance is obtained on a non-recourse basis. This, coupled with the requirement that the lessee must be *"an operator of a Hong Kong ship or aircraft"* means that the ability of lessors to obtain depreciation allowances for ships and aircrafts is quite restricted.

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An *"operator of a Hong Kong ship"* is defined as a person who:—

(a) carries on a business of operating ships and the business is managed and controlled in Hong Kong; *and*
(b) is responsible for paying all or a substantial part of the ship operating expenses and the ship operates mainly in Hong Kong waters or between Hong Kong waters and ports in the Pearl River Delta (Sec. 39E(5)).

It is also worth noting that, if the above conditions are not met, the lessor's charter hire income will not be subject to Profits Tax (see section 2.7.4), so the question of depreciation allowances would not arise in any event. Leveraged leasing of ships in international waters, therefore, cannot be undertaken to generate Hong Kong tax benefits.

An *"operator of a Hong Kong aircraft"* is defined as a person who:—

(a) carries on a business of operating aircraft and the business is managed and controlled in Hong Kong; *and*
(b) holds an air operators' certificate issued under the Air Navigation (Hong Kong) Order 1995 (Sec. 39E(5)).

Requirement (b) is highly limiting and, effectively, means that leveraged leases of aircraft in order to generate Hong Kong tax benefits are only possible where the lessee operates Hong Kong registered aircraft under Hong Kong aviation law. Foreign airlines would not be able to satisfy this requirement.

See also the discussion on loss limitation for partnerships in section 2.5.15.5; this affects the availability of loss set-offs to limited partners.

■ Example 3.17

Dragon Pacific Airlines Ltd. is incorporated in Hong Kong and has just taken delivery of a new aircraft which it will operate between Tokyo and Vancouver. To finance its acquisition it has decided to lease the aircraft from a Hong Kong registered limited partnership which has two limited partners who are substantial corporate taxpayers in Hong Kong and a general partner which is a Hong Kong company with only nominal assets. The limited partners have advanced capital to the partnership amounting to 10% of the cost of the aircraft and the balance has been financed by an advance from a bank secured by a mortgage on the aircraft.

Ignoring Sec. 39E, the partnership would be in receipt of assessable lease rentals and could claim initial and annual allowances and could deduct the loan interest.

Sec. 39E(1)(c) has to be considered and one of the two necessary requirements is not met because the bank loan is clearly "non-recourse debt," because the bank only has rights against the aircraft, partnership income and nominal assets of the general partner. To satisfy this test, the bank would have to be given the right of recourse against the assets of the limited partners to the extent of at least 41% of the cost of the aircraft so that the non-recourse part of the loan amounted to only 49% of the cost.

Alternatively, the partners might contribute a higher portion of capital. However, this is not the only test. It is also essential that Dragon Pacific Airlines be an "operator of Hong Kong aircraft." Incorporation in Hong Kong and management of its business in Hong Kong is insufficient if it is just a subsidiary of a foreign airline, operating its aircraft under the laws of another country. If however it meets the tests of a Hong Kong airline it can satisfy the requirements of Sec. 39E.

Notes:—

(a) Although Sec. 39E is not applicable, the Commissioner would consider the circumstances under Sec. 61A (see section 11.4.5) and he may decide to challenge the tax benefits accruing to the limited partners under those provisions. In the particular circumstances he would be unlikely to grant advance clearance if only because the capital contribution of 10% would be regarded as insufficient.

(b) Notwithstanding satisfying Secs. 39E and 61A, the ultimate hurdle that would destroy the tax benefits in the particular circumstances is the provisions of Sec. 22B (see section 2.5.16.5) which would limit the extent to which the limited partners could claim their share of partnership losses to be set against their own profits to the amount of their capital contribution. To overcome this, the partnership would have to be a general partnership which highlights the requirements that, to achieve tax benefits, the parties need to have substantial exposure to commercial liability.

(c) If Dragon Pacific Airlines had an option to purchase in the lease agreement, the agreement would then be a hire purchase agreement and not caught by Sec. 39E. Dragon Pacific Airlines could claim depreciation allowances under Sec. 37A but, for whether it could alternatively claim the rentals as a deduction and what the tax treatment of the partnership would be, see the discussion on what constitutes a lease in section 3.10.1.

3.10.6 Leveraged leases — machinery or plant other than ships or aircraft

Sec. 39E(1)(b) provides that initial and annual allowances are denied to a lessor of machinery or plant, other than ships or aircraft, if:—

(a) the equipment is used wholly or principally outside Hong Kong by the lessee; or

(b) the whole or a predominant part of the cost of acquisition or construction of the equipment was financed directly or indirectly by non-recourse debt (see section 3.10.4).

It should be noted that that the effect of the word "or" after (a) is that falling within either or both of the above situations will result in the denial of the allowances. The Commissioner, in DIPN 15 considers, quite logically, that finance will only be considered predominantly non-recourse where at least 51% of such finance is obtained on a non-recourse basis.

Where plant and machinery such as moulds has been provided by a

Hong Kong taxpayer to a Mainland Chinese factory enterprise under a contract or import processing arrangement, the arrangement is to be considered a lease even though no rental is charged to the factory. Because the plant and machinery is being used by the factory outside Hong Kong, strictly Sec. 39E(1)(b) would operate to deny any depreciation allowances. This point was affirmed by the Court of Final Appeal in *Braitrim (Far East) Ltd v CIR*.[27] In practice, however, the IRD does not apply the provision of Sec. 39E(1)(b) for contract processing arrangements that fall within the 50:50 apportionment concession under DIPN 21. The IRD is not prepared to extend this concession to other cases, such as import processing arrangements.[28]

In *D19/15*,[29] the taxpayer, who was a manufacturer who produced moulds and consigned them to third party factories in the PRC, sought to get around these restrictions by arguing that its expenditure on moulds was incurred on revenue account and not capital account, and it was therefore entitled to fully deduct the cost of such moulds under section 16(1). The taxpayer pointed to the fact that the moulds had a short life span, toy designs changed frequently, expenditure on moulds was recurrent and the expenditures on moulds did not add to the taxpayer's "permanent structure". The Board held that the taxpayer had failed to produce evidence to support its claims, but the decision leaves open the issue whether a taxpayer in a similar position could succeed by producing proper evidence to support its claims.

See also the discussion concerning loss limitation of partnerships in section 2.5.16.5; this affects the availability of loss set-offs to limited partners.

■ Example 3.18

Bacon Construction Company Ltd. has just taken delivery of a new earth-moving vehicle and, in view of the fact that it will only be required for two projects, had decided to lease rather than buy. It will lease from a Hong Kong registered limited partnership which has three limited partners who are substantial corporate taxpayers in Hong Kong and a general partner which is a Hong Kong company with only nominal assets. The limited partners have advanced capital to the partnership amounting to 10% of the cost of the vehicle and the balance has been financed by an advance from a bank secured by a mortgage on the vehicle.

27. (2013)16 HKCFAR 519, [2013] HKEC 1329.

28. Minutes of the 2004 Annual Meeting between IRD and Taxation Committee of the HKICPA.

29. 31 IRBRD 160.

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In year 1 Bacon used the vehicle exclusively in a construction project in Hong Kong and, in year 2, the vehicle was moved to a construction site on the Mainland where it was used except for a period of 3 months when it was brought back to Hong Kong for use in the Hong Kong project. The lease agreement was negotiated and concluded in Hong Kong.

Ignoring Sec. 39E, the partnership would be in receipt of assessable lease rentals and could claim initial and annual allowances and could deduct the loan interest.

Sec. 39E(1)(b) has to be considered and one of the two necessary requirements is not met because the bank loan is clearly "non-recourse debt" because the bank only has rights against the equipment, partnership income and nominal assets of the general partner. To satisfy this test, the bank would have to be given the right of recourse against the assets of the limited partners to the extent of at least 41% of the cost of the equipment so that the non-recourse part of the loan amounted to only 49% of the cost. Alternatively, the partners might contribute a higher portion of capital. As Bacon satisfies the second test by wholly using the equipment in Hong Kong in year 1, Sec. 39E(1)(b) would not be applicable and the allowances would not be denied under Sec. 39E so long as the financing structure was changed as indicated.

In year 2 it could not be said that the equipment is predominantly used in Hong Kong; therefore Sec. 39E(1)(b) would be applicable, even if the financing was restructured, and no annual allowance is available for year 2. Further, on the basis of DIPN 15 (see section 3.10) the rentals in year 2 would generally be considered to be exempt from Profits Tax on the grounds that the equipment is used predominantly outside Hong Kong and, therefore, the interest would also cease to be deductible. This overall situation may not be satisfactory to the limited partners as they may have been expecting the partnership to sustain a loss after deduction of depreciation allowances and interest, with such loss being available to shelter some portion of their other profits. It is therefore apparent that the partnership is, in effect, at the mercy of Bacon in relation to obtaining allowances and it would have to dictate the place of use in the agreement if it was to avoid the problem.

Notes:—

(a) Even if Sec. 39E is not applicable in year 1, the Commissioner would consider the circumstances under Sec. 61A (see section 11.4.5). In the particular circumstances, he would be unlikely to grant advance clearance if only because the capital contribution of 10% would be regarded as insufficient.

(b) Notwithstanding satisfying Secs. 39E and 61A, the ultimate hurdle that would destroy the tax benefits in the particular circumstances is the provisions of Sec. 22B (see section 2.5.16.5) which would limit the extent to which the limited partners could claim their share of partnership losses to be set against their own profits to the amount of their capital contribution. To overcome this, the partnership would have to be a general partnership which highlights the current requirements that, to achieve tax benefits, the parties need to have substantial exposure to commercial liability.

3.11 Miscellaneous Points Relating to Depreciation Allowances

There are some provisions which are not related just to one class of depreciation allowances but which cover the application of depreciation allowances in general. These are discussed below.

3.11.1 Basis periods

It is, of course, necessary to relate depreciation allowances to a year of assessment. This is achieved in the same way as profits or losses are related to a year of assessment in that events which govern the allowances (acquisition, disposal, use, etc.) give rise to adjustments for the year of assessment of which the period in which these events occur is the basis period.

However, this general rule cannot be applied where an event falls into a period which either falls out of account in computing profits or which forms the basis period or part of a basis period for more than one year of assessment. These situations can arise on commencement, cessation of business or change of accounting date (see sections 2.6.2 to 2.6.4). In these circumstances the rules in Sec. 40(1) are as follows:—

(1) where two basis periods overlap, the period which is common to both is deemed to fall into the first basis period only; or

(2) where there is an interval between the end of a basis period for one year of assessment and the beginning of a basis period for the next year of assessment, the interval is deemed to fall into the second basis period.

■ Example 3.19

Because of a change of accounting date from 31 December to 30 June, a company's Profits Tax assessments for 2012/13 and 2013/14 are based on the following basis periods:—

2012/13	Year ended 31 December 2012
2013/14	12 months to 30 June 2013

The company purchased a machine on 31 December 2012 and a lorry on 1 January 2013.

As the period 1 July 2012 to 31 December 2012 is common to both 2012/13 and 2013/14, this period is deemed to fall only into the basis period for 2012/13 for depreciation allowance purposes. Accordingly the machine purchased on 31 December 2012 qualifies for initial allowance for 2012/13 and for annual allowances for 2012/13 and 2013/14 but the lorry qualifies for initial and annual allowances only for 2013/14.

■ Example 3.20

A company whose normal accounting date was 31 December and which had been in business for 40 years, changed its accounting date to 31 March as a result of which Profits Tax assessments were based on the following basis periods:—

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(ii) **Sec. 70A**: An application for the Commissioner to correct an assessment within the six year time limit assessment if the tax charged is excessive by reason of an error in the tax return. Moulin contended, only in respect of the 2003/04 tax year, that tax was overpaid due to errors in the return because the directors had deliberately and fraudulently overstated the company's profits.

The Commissioner rejected the liquidators' application on the grounds that the relevant returns were filed by the company with knowledge of the fraud.

On the liquidators' application for judicial review the Court of First Instance,[4] relying on the general law of agency, found in favour of *Moulin*, holding that an agent's fraud can never be attributed to his principal (*Moulin*), and ordered the Commissioner to reconsider her decisions. In 2012, the Court of Appeal[5] allowed the Commissioner's appeal and seT aside the lower court's orders. The Court of Appeal concluded that alternative rules of attribution that facilitated the statutory intent of the Inland Revenue Ordinance should be applied. It held that the fraudulent knowledge of Moulin's directors that the profits had been falsely overstated should be attributed to the company. Consequently, *Moulin* had not been prevented from giving notice of objection within the stipulated time (Sec. 64(1)(a)), nor was there any error within the meaning of Sec. 70A. The Court of Appeal granted leave to appeal so that the law relating to attribution could be considered and authoritatively stated by the Court of Final Appeal.

The Court, placing great reliance on the attribution of fraudulent knowledge to *Moulin* as well as issues of public policy, unanimously dismissed the appeal under Sec. 64(1)(a) and, by a majority (Tang PJ dissenting), dismissed the appeal under Sec. 70A.

Having reviewed the facts and the language and legislative purpose of the statutory provisions contained in the Inland Revenue Ordinance, the Court held that the knowledge of the fraudulent directors should be attributed to *Moulin*. The leading judgment of Lord Walker of Gestingthorpe NPJ included a detailed restatement of the *law of attribution* of the fraud of directors of a company to the company itself, and defined the limits and scope of the *fraud exception* to the attribution rules (which is where the

4. [2011] 3 HKLRD 216, HCAL 29/2010.
5. [2012] 2 HKLRD 911, CACV 64/2011.

company seeks to be insulated from the knowledge of its fraudulent directors where the company is the victim of the fraud). The Court acknowledged the importance of having a fair and efficient tax system which can be expected to produce public revenue to a more or less predictable level. Equally, prompt payment and finality within a reasonably short time were important policy aims of the provisions of the ordinance being addressed in this appeal. As it is an essential part of the scheme of the ordinance that the Commissioner is able to make assessments on the basis of the taxpayer's returns, it would frustrate this statutory purpose if the fraud exception were to intrude into this scheme. Lord Walker therefore concluded that the fraud exception must be limited to its proper, limited role of barring unmeritorious defences in claims by corporate employers against dishonest directors or employees and their accomplices.

Consequently, the Court held that the fraud exception should not apply to the claim against the Commissioner and the fraudulent knowledge of the directors would be attributed to the taxpayer. As a result, the liquidators could not rely on the proviso in Sec. 64 because *Moulin* was not "prevented" from lodging an objection in time: it chose not to do so. Nor could the liquidators rely on Sec. 70A, because *Moulin*, knowing that the return was false, had not made an "error" in the return but had instead told a deliberate "lie" in it.

The decision of the Court of Appeal is significant for two reasons. Firstly, it clarifies the legal principles governing the attribution of directors' knowledge to a company while adopting a narrow interpretation of the fraud exception to such attribution of knowledge. Secondly, the Court has taken a broad public policy approach to ensure the finality of assessments within the statutorily intended timeframe, even if creditors may lose substantially through overpaid tax on falsified profits. The importance to taxpayers of this decision is that overstated tax liabilities arising from the fraudulent conduct of directors will not, in most cases, be recoverable from the Commissioner notwithstanding the fact that auditors and/ or liquidators may discover such fraud within the limited time allowed by the law.

In *Chan Chun Chuen v CIR*[6] the taxpayer's case was that it had not received the property tax and profits tax assessments and accordingly was not in a position to object to them ("prevented from giving . . . notice [of objection]") within the prescribed time. The Court considered: whether the Commissioner must establish actual receipt of an assessment; whether

6. [2012] 2 HKLRD 379, CACV 113/2011; HCAL 76/2010.

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the Commissioner was required to send assessments to more than one last known address; whether lack of actual knowledge is a basis for extending the time limit for objection; and whether the Commissioner reasonably rejected the request for an extension of time. The Court considered that the Commissioner's approach had been too narrow in considering whether there was reasonable cause to be satisfied that the taxpayer was prevented from objecting in time and that the Commissioner acted unreasonably in refusing to grant an extension. The case was remitted to the Commissioner for reconsideration.

This decision was appealed by the Commissioner and the Court of Appeal affirmed the Court of First Instance's decision on the first point. That is, the taxpayer was out of time as the objection was raised beyond the one month period from the respective dates of the assessments. The "giving" of notice does not imply "receipt" by the taxpayer, in the sense that he must have actual knowledge of the notice. Sec. 58(2) governs notice by way of postal service. Once it is invoked the Commissioner does not need to show further that the notice had "actually" come to the knowledge of the taxpayer.

Sec. 58(3) merely provides the rebuttable presumption on the time that the notice sent by post is deemed to have been served, namely, on the day succeeding the date on which the notice would have been received in the ordinary course by post. Under Sec. 64(1), time starts to run for the purpose of objection within one month after the date of the notice of assessment (on the basis that it has been given by way of proper service) and not from the date of service of the notice of assessment.

The requirement of giving notice under Sec. 62(1) and the method of service under Sec. 58(2) strike a proper balance between, on the one hand, the right of a taxpayer to be notified of the relevant documents and, on the other hand, the administrative and practical convenience of an effective system of tax assessment and collection. The Commissioner's duty is discharged by choosing any one of the methods of service under Sec. 58(2) because each one is equally lawful and effective.

The Court of Appeal noted that whether the Commissioner should grant an extension of time or not is a matter entirely for him to decide. The focus on the correctness of the Commissioner's decision on extension of time must be based on the material that was available to him at that time. The basis of the extension sought was simply that the taxpayer had not received the assessments because the solicitors had not received the assessments.

The Commissioner in considering the request for extension referred to

the acknowledgement by the solicitors of the receipt of the two profits tax assessments and the lack of record that the other 23 property tax assessments which were sent by ordinary post were not delivered. On the basis of this material, the Commissioner was not satisfied that the assessment was not received by the solicitors. The Commissioner's conclusion that she was not satisfied that owing to absence from Hong Kong, sickness or other reasonable cause the taxpayer was prevented from giving notice of objection within the statutory period could not be faulted.

The Court of Appeal concluded that, looked at in the round, the Commissioner must be of the view that it was plainly too much of a coincidence that all 25 assessments which were sent at different times would not have reached the taxpayer. It is not sufficient for the taxpayer to say that he had not received the assessments. The so-called difficulties of proving a negative can only be carried so far. They must be viewed in their proper perspective having regard to the circumstances of the case. If the taxpayer wished to challenge the solicitor's assertion that the assessments had been supplied to his agents, there should be evidence of further inquiries with the staff of their action. There was none in the present case. Accordingly, there was no proper ground to challenge the correctness of the Commissioner's refusal to extend time.

The taxpayer lodged an application for leave to appeal the decision but this was refused.

There is a further requirement in the case of an assessment made under Sec. 59(3) (i.e. estimated assessment made in the absence of a return). In such cases, it is not sufficient to just object in accordance with (1), (2) and (3) above that the estimate is incorrect and may prove to be excessive (which is a satisfactory ground for an estimated assessment). Rather, for the objection to be valid, the relevant return (including all the documents required to be submitted in connection therewith) must also be submitted within one month from the issue of the notice of assessment or such extended period as the Commissioner in his absolute discretion may allow (Sec. 64(1)(b)). It is not essential that the objection and the return be submitted together; it is usually desirable to submit the objection immediately and then to submit the return, if possible, within the required month or, if not possible, to seek a reasonable extension of time to submit the return. It is essential to realise that, failing the causes mentioned in (3) above, it is not possible to extend the time for objection but, given a good reason, a reasonable extension for submission of the return will often be given. If, however, the return is not submitted within the time limit given, the objection is not valid and the estimated assessment becomes final and conclusive.

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In respect of composite tax returns, the more onerous provisions of Sec. 64(1)(b) as discussed in the previous paragraph apply where, although a return has been lodged, it failed to disclose details of a source of income, property or profits and the assessment is estimated by the IRD in respect of that source of income, property or profits (Sec. 64(1A)). In other words, if, e.g., a taxpayer lodges a composite tax return which discloses his income chargeable to Profits Tax but omits details of his income chargeable to Property Tax, the IRD can issue an estimated Property Tax assessment and an objection will not be valid unless the details required on the return form are provided within one month of the issue of the notice of assessment or such further time as the Commissioner may, in his discretion, allow.

If the assessment comprises a re-assessment which either increases or reduces the person's liability to tax (such a re-assessment would normally result from an objection against the original assessment), no new right of objection arises except in relation to any new or additional liability imposed by the re-assessment (Sec. 64(1) proviso (c)).

Where no tax is payable, i.e. where there is a loss, even after the disallowance of a disputed item, no objection can be made.[7] When, however, the disputed loss is applied against subsequent profits leaving a net assessment, an objection can be made against the net assessment.

Also, an objection against a total income assessment under the Personal Assessment procedure can only be against the composition of that assessment from agreed amounts of income under the income taxes. It cannot have the effect of re-opening any existing assessment under any of the income taxes which is already final and conclusive. The objection can, however, be effective in respect of the allocation to the individual of his share of the agreed profits of a partnership of which he is a partner (Sec. 64(7)). However, any objection by an individual involving the allocation of the profits of a partnership is treated as an objection by all of the partners so that they are all bound by its determination (Sec. 64(8)). An objection against a Personal Assessment upon a married person, which includes income of the other spouse, is deemed to include an objection by that other spouse (see section 10.4).

In addition to all of the other requirements, a person must have a legal capacity to file an objection. In the case of a deceased person, the power to object is vested in the executor of the person by Sec. 54. Similarly, it appears that where a person is adjudged bankrupt, the power to object

7. *D 2/82* 1 IRBRD 410.

becomes vested in the person's trustee or, where no trustee has been appointed, the Official Receiver.[8]

10.2.2 Negotiation of objection

Upon receiving a valid objection, Sec. 64(2) provides that the Commissioner may confirm, reduce, increase or annul the assessment objected to. Other than where the Commissioner allows the objection in full, an assessment will usually only be increased, decreased or confirmed with the agreement of the taxpayer pursuant to Sec. 64(3), which is discussed further below, although the assessment may also be confirmed where the taxpayer withdraws the objection. This is because if there is no agreement (or withdrawal of the objection), the matter must proceed to a Commissioner's determination in accordance with Sec. 64(4), which is discussed in section 10.2.3. The duties of the Commissioner under Sec. 64(2) are, in practice, delegated to individual assessors.

In order to ensure progress of an objection, the Commissioner is empowered by Sec. 64(2) to give written notice of further information required including production of any relevant books or documents. He may also give notice to any person to attend and give oral evidence in connection with the objection. Where, however, the Commissioner intends to examine any person on oath, he is required to give written notice of his proposed action to the taxpayer who has lodged the objection in order that such taxpayer, or his authorised representative, may be present at the examination. An authorised representative may also, of course, act in supplying any information or documentation requested.

Sec. 64(2) also imposes upon the Commissioner a duty to act within a reasonable time to confirm, reduce, increase or annul the assessment against which the objection was lodged. In the case of *Wang v CIR*[9] the taxpayer sought a court order to quash certain objection determinations on the grounds that it had taken the Commissioner several years to issue them and that he had not, therefore, acted within a reasonable time. The Privy Council, in agreeing with the Court of Appeal and overturning the High Court, held that even if the Commissioner had not acted within a reasonable time, the legislation should not be interpreted as taking away a statutory power granted to the Commissioner simply because he was slow in exercising that power. Accordingly, the Privy Council held that it was

8. *D 79/04* 19 IRBRD 606.
9. [1994] 1 WLR 1286; [1994] STC 753.

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not appropriate to quash determinations, or to prevent the Commissioner from issuing determinations, on the grounds that he had been slow in dealing with the objections in question.

In view of the above, it seems that in cases where the Commissioner is dilatory in dealing with an objection, the only action open to a taxpayer is to seek a court order to force the Commissioner to determine the matter, although it is likely that the taxpayer would need to show that he had suffered prejudice before such an order was granted. In this regard, see the decision of the Court of Appeal in *Tak Wing Investment Company Ltd v CIR*.[10] In that case the taxpayer was seeking a stay of enforcement action in respect of an assessment to which it had objected, and in respect of which the Commissioner had been slow in determining that objection. The essence of the taxpayer's case was that the tax in dispute would become refundable if the objections were ultimately allowed, and therefore the taxpayer was possibly being prejudiced by the Commissioner's tardiness in dealing with the objection. Although refusing to stay the enforcement action, the court agreed to grant the taxpayer leave to apply for judicial review of the Commissioner's failure to determine the objection and for an order for mandamus compelling the Commissioner to determine the objection.

In *Yue Yuen Marketing Co Ltd v CIR*,[11] the taxpayer applied for a judicial review of profits tax assessments made before the expiry of the six year limitation period provided by Sec. 60. The taxpayer objected to each assessment in accordance with Sec. 64(1) but the Commissioner had not yet made a determination on any of the objections. The court refused to uphold the taxpayer's request to have the assessments quashed on the basis of non-compliance with Sec. 64(2). However, applying *Wang's* case, an order of mandamus was given requiring the Commissioner to determine the objections. Based on the above cases, it appears that a "reasonable time" must be considered in the light of all the circumstances.

It is usual for the negotiation of an objection to proceed through correspondence and for a revised assessment to be based upon an agreement reached between the assessor (under power delegated from the Commissioner) and the taxpayer. In the case of certain joint assessments on a husband and wife, the agreement of both husband and wife must be obtained (see section 9.4). Upon the assessment being adjusted in

10. [2001] 2 HKLRD 266.

11. [2012] 4 HKLRD 761. See further: *Kong Tai Shoes Manufacturing Co Ltd v CIR* [2012] 4 HKLRD 780; *Canray International Ltd and others v CIR* [2012] 4 HKLRD 792.

accordance with the agreement it becomes final and conclusive (Sec. 64(3)). Where a notice is issued requesting information under Sec. 64(2), such notice will contain a date by which the information is required and if that deadline is not met, a fine may result (see section 7.4).

If the assessor does not agree to make any adjustment or does not agree to make the adjustments sought by the taxpayer, he will submit the case to the Commissioner for determination.

For the purposes of negotiating an objection, the Commissioner is granted certain powers under the *Commissions of Inquiry Ordinance* (Sec. 64(5)).

10.2.3 Commissioner's determination

When the assessor cannot reach agreement with the taxpayer or his representative on the determination of an objection, the matter must be formally determined by the Commissioner. In practice, determinations are made by the Commissioner or a Deputy Commissioner or, in respect of Property Tax cases, by an Assistant Commissioner, Unit 2. The Commissioner can determine the assessment in any amount which he can justify but it will, of course, be an amount with which the taxpayer does not agree because otherwise the objection could be settled by agreement under Sec. 64(3). Once the Commissioner has made his determination he must, within one month, send a written notice of his determination to the person who lodged the objection and such notice must contain a statement of the facts upon which the determination is based and also the reasoning behind the determination (Sec. 64(4)).

In practice, the assessor will prepare the statement of facts beforehand and he usually sends them to the taxpayer who lodged the objection for his agreement or observations. Although the assessor has no statutory obligation to present the facts prior to agreement, it is obviously in the interests of all parties to do so in the event of the case proceeding to hearing before the Board of Review, because the statement is submitted to the Board of Review in an appeal. In practice, however, the Commissioner does not regard himself as bound by the statement of facts submitted to him; in particular, he may exclude facts which he may deem to be irrelevant to the point at issue and may include facts which have emerged from correspondence which he considers should be included.

If the person does not appeal against the Commissioner's determination, the assessment as determined becomes final and conclusive.

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10.3 Appeals

An appeal is different from an objection in that it is presented to an independent tribunal for determination. There are a number of levels of appeal beginning with a semi-formal hearing before the Board of Review and possibly proceeding through the Court of First Instance and Court of Appeal to the Court of Final Appeal.

10.3.1 Board of Review

If a person does not agree with the Commissioner's determination of his objection, he has the right of appeal to the Board of Review.

Sec. 66 lays down the following requirements which must be met for an appeal to be valid.

(1) notice must be given to the Clerk to the Board of Review in writing by the taxpayer or his authorised representative;

(2) such notice must be given within one month of the transmission to the taxpayer of the Commissioner's determination. The one month period runs from when the transmission of the Commissioner's determination to the taxpayer was completed (i.e. from when it was delivered to the taxpayer's address) and not from when it was despatched by the IRD.[12] Moreover, the one month period is measured against the date the notice of appeal is received by the Board of Review rather than the date the notice was posted by the appellant. The Board of Review may extend the one month time limit to whatever period it considers fit in the event that the appellant was prevented by illness, absence from Hong Kong or other reasonable cause from giving the notice within one month (Secs. 66(1) and 66(1A)). The power of the Board to extend the time for lodging an appeal has been interpreted as applicable only in cases where a taxpayer has taken no steps whatsoever to appeal. In particular, the Board has held that the provision confers no power to extend the time for submitting the grounds of appeal or any other necessary documents once an actual notice of appeal has been lodged. Furthermore, it is important to note that the power to extend the time for lodging an appeal is not a general one but can be exercised only where the Board of Review is satisfied that the taxpayer was prevented from lodging the appeal. That is, it is not

12. *D2/04* 19 IRBRD 76, and *D50/07* 22 IRBRD 428.

enough that the taxpayer was too busy or simply forgot.[13] Indeed, even absence from Hong Kong or illness are not guaranteed to result in the Board of Review exercising its power to extend the time for filing.[14] Another interesting case which emphasised the need to be able to demonstrate that the taxpayer was prevented from filing a notice of appeal in order for the time limit to be extended is *CIR v Chow Kwong Fai, Edward*.[15] The Court of First Instance in that case held that, notwithstanding that the Clerk to the Board of Review had provided incorrect advice to the taxpayer, there was no evidence that such advice had prevented the taxpayer from filing a valid notice of appeal within the statutory time limit. That decision was upheld on appeal by the Court of Appeal. However, the Board of Review has extended the time for lodging an appeal where the IRD sent the Commissioner's determination to the wrong address[16] and when a misleading answer was given by the office of the Clerk to the Board of Review;

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(3) the notice must be accompanied by a copy of the Commissioner's determination, the statement of facts upon which the determination is based and a statement of the grounds of appeal (Sec. 66(1)). A failure to include the Commissioner's determination (or indeed any other of these documents) will render the notice of appeal invalid. If an appellant fails to include a copy of the determination (or other required documents) it appears to be the practice of the Clerk to the Board of Review to invite the appellant to provide it and, as long as it is provided within the one month period for filing the notice of appeal, that appeal will be treated as valid. As noted above, however, it seems that Sec. 66(1A) cannot be invoked to obtain an extension of time to file a requisite document (such as the Commissioner's determination);[17] and

(4) a copy of the notice of appeal including the grounds of appeal must be sent to the Commissioner (Sec. 66(2)).

In addition to the above requirements, it is also important to remember that a person must have a legal capacity to file an appeal. In the case of a

13. *D96/99* 14 IRBRD 614, and *D105/99* 14 IRBRD 627.
14. *D19/01* 16 IRBRD 183, and *D4/07* 22 IRBRD 240.
15. [2004] 2 HKLRD 963; HCAL 47/2004.
16. *D28/07* 22 IRBRD 617, and *D62/98* 13 IRBRD 385.
17. *D2/07* 22 IRBRD 219.

deceased person, the power to object is vested in the executor of the person by Sec. 54. Similarly, where a person is adjudged bankrupt, the power to appeal becomes vested in the person's trustee or, where no trustee has been appointed, the Official Receiver.[18]

Whilst the grounds of appeal do not have to agree with the grounds for the original objection, no grounds can be relied upon at the Board's hearing of the appeal other than those contained in the notice of appeal, except with the specific consent of the Board (Sec. 66(3)). This provision, however, does not apply to prevent the IRD from relying on arguments before the Board of Review which were not contained in the Commissioner's determination.[19]

The Board of Review is an independent body of persons appointed by the Chief Executive and the constitution and powers of its members are laid down by Sec. 65. At a hearing of an appeal there are usually three members constituting the panel of which the head (who is either the Chairman or a Deputy Chairman of the Board of Review) must have legal training and experience (Sec. 65(1)). The other members of the panel may or may not have legal experience but, if not, will otherwise be members of the community selected for the experience and knowledge which they can bring to the panel.

The hearing of the appeal is an informal matter or at least lacks the strict formality of a court hearing. The hearing is in private but many cases are published for information purposes in a manner which does not reveal the identity of the appellant (Sec. 68(5)). Either the appellant in person or his authorised representative can, and commonly does, conduct his case although from time to time counsel is briefed to conduct the hearing on behalf of the appellant. Also, from time to time, counsel is briefed to conduct the Commissioner's case, although this is more usually done by an officer of the IRD.

Despite the lack of formality, Sec. 68 sets down a number of regulations concerning the hearing of appeals by the Board. First, the section provides that unless the appeal is transferred for direct hearing by the Court of First Instance pursuant to Sec. 67 (see section 10.3.4), or the Board endorses under Sec. 68(1B)(b) a settlement reached between the appellant and the Commissioner (see below), the Clerk to the Board is charged with the responsibility of fixing the time and place of the hearing

18. *D79/04* 19 IRBRD 606.

19. *D27/91* 6 IRBRD 65.

as soon as possible and giving at least 14 days' notice to the appellant and the Commissioner. The hearing cannot be fixed, however, for a time before the expiry of the time limits within which the appeal can be set down for direct hearing by the Court of First Instance (Sec. 68(1)). In practice, the hearings are at the Board of Review offices, either during the day or in the evening, with the number of sessions set aside depending upon the complexity of the case. At any time prior to the scheduled hearing, the appellant can withdraw his appeal by giving notice in writing to the Clerk to the Board of Review (Sec. 68(1A)(a)), in which case the hearing is, of course, cancelled. In such circumstances, the assessment will become final and conclusive, although Sec. 68(1D) allows an assessor to raise an additional assessment in accordance with the normal provisions (see section 8.2.4). Note that although Sec. 68(1A) allows an appellant to withdraw an appeal before the hearing of that appeal, there is no right of withdrawal once the hearing has commenced. This has been confirmed by the Board of Review where a hearing was adjourned to allow the appellant company additional time to prepare its case; following the adjournment, the appellant applied to withdraw the appeal but this was rejected by the Board of Review as not being permitted by Sec. 68(1A).

Prior to 13 June 1997, a hearing was still required to be held even if the appellant and the Commissioner agreed as to a basis for settlement of the dispute. In such circumstances, the hearing was usually a formality to endorse the settlement, although occasionally this was not so.[20] From that date, however, a statutory procedure was introduced by which a hearing can possibly be avoided in such circumstances. In particular, Secs. 68(1A)(b) and 68(1B) provide that, where a settlement of the appeal is reached between the parties at any time prior to the hearing, the terms of such settlement shall be reduced to writing in a form specified by the Board, signed by both parties and submitted to the Board for endorsement. The Board does not, however, have to endorse the settlement and, in such circumstances, the hearing shall proceed (Sec. 68(1E)), unless of course the appellant decides to withdraw the appeal. The Board may have a number of reasons for not endorsing a proposed settlement, e.g., the Board may not consider that it is in accordance with the law or may wish to satisfy itself that the appellant has fully understood the terms of the settlement. In any event, there is nothing to prevent the Board from endorsing the settlement after holding a hearing.

20. *D37/95* 10 IRBRD 261.

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If, however, the Board does endorse the settlement without a hearing, Sec. 68(1C) provides that any necessary adjustments shall be made to the relevant assessments and such assessment shall be final and conclusive for all purposes of the IRO as regards the amount of the relevant income, profits or net assessable value, save that Sec. 68(1D) permits an assessor to raise an additional assessment in accordance with the normal provisions (see section 8.2.4), provided it does not involve reopening any matter which has been endorsed by the Board.

Where a hearing is held, the appellant or his authorised representative must attend the hearing in person (Sec. 68(2)) but if either fails to appear at the appointed time the Board has the option, pursuant to Sec. 68(2B), of:—

(1) postponing or adjourning the hearing if it is satisfied that the absence is due to sickness or other reasonable cause. In *D58/93*, the Board of Review held that the fact that the appellant was outside Hong Kong was not, by itself, a reasonable excuse for failing to appear at the hearing;
(2) hearing the appeal pursuant to Sec. 68(2D). This does not give the Board of Review a broad power to hear a case in the absence of the appellant or his authorised representative; rather, it applies only where the appellant has applied at least seven days before the scheduled hearing for the case to be heard in his absence and the Board is satisfied that the appellant will be outside Hong Kong on the date of the hearing and is unlikely to be in Hong Kong within such period thereafter as the Board considers reasonable; or
(3) dismissing the appeal.

What this means is that if the Board of Review is not satisfied that the appellant's absence is due to absence or other reasonable cause and the appellant has not applied pursuant to Sec. 68(2D) for the case to be heard in his absence, the Board has no choice but to dismiss the appeal.[21]

In *D135/02*,[22] the Board of Review had to consider whether it could exercise its powers under Sec. 68(2B) in a case where an appellant appeared not to have received the notices of the hearing, as they had been returned undelivered from an overseas address and the appellant had made no attempt to contact the Board of Review or the IRD for four years. The Board of Review held that it could exercise its powers in such circumstances on the basis that there was no explicit requirement in Sec. 68(2B)

21. *D6/07* 22 IRBRD 261.
22. 18 IRBRD 231.

for the appellant to have actually received the notice of the hearing and that the failure of the appellant to make contact with the Board of Review for an extended period could be regarded as not attending any hearing properly fixed by the Clerk. The Board of Review has also considered that the facts that a warrant for the arrest of the taxpayer on criminal charges had been issued, and the taxpayer did not want to return to Hong Kong for fear of arrest, did not amount to a reasonable excuse for not attending the hearing. The Board therefore exercised its power under Sec. 68(2B)(c) to dismiss the appeal.[23]

If the appeal is dismissed, the appellant has the chance, within 30 days after the order, to request the Board of Review to reconsider its decision in the light of facts which he may bring to show that due to sickness or other reasonable cause an appearance was not possible. If satisfied, the Board will amend its order and hear the appeal (Sec. 68(2C)).

Where the appellant has applied under Sec. 68 (2D) for the case to be heard in his absence, the Board may consider the appellant's written submissions (Sec. 68(2E)). An officer of the IRD must attend the hearing as there is no provision for his absence (Sec. 68(3)).

At the hearing, the facts as contained in the Commissioner's statement of facts are normally accepted unless challenged by the appellant. Also, any additional facts sought to be introduced will usually be accepted if such facts have been agreed between the Commissioner and the appellant but, if not so agreed, will have to be supported by appropriate oral or documentary evidence. Both the appellant and the Commissioner's representative are entitled to seek to adduce additional facts or evidence; in either case, however, when considering such evidence the Board of Review may accept or reject it as it sees fit and it is specifically provided that the provisions of the *Evidence Ordinance* (which sets out the rules as to admissibility of evidence in court hearings) is not to apply (Sec. 68(7)). See, however, the discussion in section 10.3.2 regarding further appeals on findings of fact and, in particular, the power of the courts to review perverse findings of fact by the Board of Review.

In hearing evidence, the Board of Review has power to summon witnesses as necessary and pay their reasonable expenses (Sec. 68(6)).

Under Sec. 85(2)(d), the Board of Inland Revenue has the power to prescribe procedures to be followed in relation to appeals to the Board of Review, but until 2016, no such rules had been prescribed. However, and

23. *D46/03* 18 IRBRD 552.

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with effect from 1 April 2016 and the introduction of a new Sec. 68AA, the person presiding at a Board of Review hearing now has the power to give directions on the provision of documents and information for the hearing and can refuse to admit any documents and information as evidence in the hearing of an appeal if they are not produced in compliance with the directions given. It is usual for the Board of Review to hear the appellant's case first, during which the Commissioner's representative is allowed to question any witnesses brought by the appellant, then to hear the Commissioner's case, allowing the appellant or his representative to question any witnesses, and finally to permit the appellant's final comments.

Following the hearing the members of the Board will meet and reach their decision which will be to confirm, reduce, increase or cancel the assessment or they may remit the assessment back to the Commissioner to make whatever adjustments are necessary consequent upon their decision (Sec. 68(8)). If the assessment is not cancelled or reduced, the Board is empowered to impose costs of up $25,000 (Sec. 68(9)). It is generally accepted that the intention of this provision is to deter vexatious or trivial appeals but it is questionable whether or not it is an effective deterrent. Historically, it was only on rare occasions that the Board of Review would order costs be imposed. In recent years, however, it has become relatively common.[24]

Sec. 68(4) provides that, at the hearing of an appeal, the onus of proof is on the appellant to prove that the assessment is excessive or incorrect. One of the earliest cases on this provision is *In re Herald International Ltd*[25] and an excellent summary of that decision as well as subsequent cases on the interpretation of the provision is contained in *CIR v Common Empire Ltd*.[26] Additionally, it should be noted that, in *D31/87*,[27] the Board of Review rejected the IRD's submission that the onus of proof was "a heavy one" and held that, in fact, Sec. 68(4) means no more than that the appellant must substantiate his case. It seems, therefore, that an appeal should be decided on the basis of the balance of probabilities, rather than placing upon the taxpayer a requirement to produce incontrovertible evidence to disprove the Commissioner's contentions. This view also

24. *D131/00* 16 IRBRD 1, and *D11/11* 26 IRBRD 244.
25. 1 HKTC 393 [2007].
26. (2007) HKTC 52, [2007] 1 HKLRD 697.
27. 2 IRBRD 409.

appears to have been accepted by the Court of Appeal in *Chanway Investment Co. Ltd. v CIR*.[28]

See also *CIR v Tsai Ge Wah*,[29] which concerned the assessability of a payment received in connection with the termination of employment, but a relevant fact for consideration was whether any part of the relevant payment was made in accordance with the *Employment Ordinance*. The Board of Review had found that a portion of the payment was so made, principally by examining the main relevant provisions of the *Employment Ordinance* and considering the taxpayer's testimony. The Board did not, however, consider whether certain other provisions of that ordinance may have operated to deem a payment not to have been required. On appeal, the Commissioner's counsel sought to argue that, as no evidence had been adduced on this point, the taxpayer had not discharged the burden of proof of establishing his case. The Court of First Instance rejected this argument, however, and held that requiring the taxpayer to establish a negative (i.e. to show that none of the circumstances which would have overridden the application of the general provision existed) was not required by Sec. 68(4), particularly where there was no suggestion that any of those provisions may in fact have applied.

Notwithstanding the above, it is quite common for the Board of Review to find for the IRD on the basis that the taxpayer has not discharged the burden of proof. This raises a question of how far the Board of Review should go to actually rule on the arguments advanced by the parties. This point was considered in *China Map Ltd & Others v CIR*[30] where it was held that it is open to the Board of Review to simply dismiss a case on the basis that the burden of proof has not been discharged without going on to make a positive finding of facts related to the substantive issue. In that case, the taxpayer failed to satisfy the Board of Review that certain profits were of a capital nature; on appeal, the taxpayer argued that the Board should have found as a fact that a trade was carried on in relation to the relevant assets. That argument was, however, rejected by the Court of First Instance which held that it was not necessary for the Board to reach a conclusion on such a matter if there was insufficient evidence on which to do so. In such a case, it was quite proper for the Board to find against the appellant taxpayer on the basis of the burden of proof. This view was

28. [1998] 1 HKC 712.
29. (2008) 7 HKTC 987.
30. [2007] 4 HKLRD 247; FACV 28, 29, 30, 31/2007.

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upheld on appeal to the Court of Appeal. This matter was further considered in *Real Estate Investments (NT) Ltd v CIR*[31] which held that disposing of cases on the onus of proof is rare and exceptional. But there were features of this case which might have caused the Board to see this as one of those rare and exceptional occasions for deciding a case on the onus of proof. The taxpayer advanced three different explanations of its motivation and this was compounded by the fact that the Board had to cope without the benefit of any evidence from a witness whose unavailability as a witness perhaps resulted in the taxpayer not leading important evidence which it would otherwise have led. The Court noted that "It has often been said," as Lord Reid observed in *Dorman Long (Steel) Ltd. v Bell*[32] "that after all the evidence has been led the initial onus of proof is rarely of importance." See, however, *D25/90*[33] where the Board of Review held that, where the Commissioner is alleging the existence of a partnership, the burden of proof is reversed and falls upon the Commissioner.

In *Brand Dragon Ltd and Harvest Island International Ltd v CIR*,[34] an appeal from the Board of Review, the taxpayer unsuccessfully sought to argue that the burden of proof was reversed because the Board of Review rejected certain board minutes and other evidence adduced as being self-serving. In particular, the taxpayer sought to argue that the Board of Review was effectively arguing that the relevant documents were shams and that, in such circumstances, the Commissioner should be required to prove his contention. The Court of First Instance rejected this argument on the basis that the Board of Review was required to assess and test all evidence placed before it and could accept or reject evidence as it considered appropriate. However, just because it chose to reject or place little weight on evidence did not necessarily mean that it was considered a sham.

Note that in the somewhat unusual circumstances where an appellant acts for a deceased person, the Board of Review has held[35] that the onus of proof is no less than it would have been for the deceased, even though the appellant may be disadvantaged by not being able to bring evidence known only to the deceased.

31. (2008) 11 HKCFAR 433, FACV no. 3 of 2007.
32. [1964] 1 WLR 333 at 335.
33. 5 IRBRD 187.
34. [2002] 1 HKRC § 90-115.
35. *D14/83* 2 IRBRD 47.

Apart from the foregoing cases, the interpretation of Sec. 68(4) has been considered in a number of other court decisions in Hong Kong. A summary of the principles arising from those cases, can be found in *D55/03*.[36]

The decision of the Board of Review, together with the reasons therefor, is notified later to the appellant in writing, his authorised representative if there is one, and the Commissioner. The chairman usually prepares the written determination and, therefore, the delay between the hearing and the written determination depends upon the workload of the chairman.

Penalty assessments under Sec. 82A are also subject to the appeal procedure (see Chapter 8). As such assessments have to be made by the Commissioner or a Deputy Commissioner personally, disputes proceed directly to the Board of Review because the objection procedure would be a mere formality.

The unsuccessful party to a Board of Review hearing, whether it be the appellant or the Commissioner, is entitled, in certain circumstances, to appeal to the Court of First Instance or the Court of Appeal. In the absence of such further appeal, the assessment becomes final and conclusive in accordance with the Board's decision.

10.3.2 Appeal against decision of Board of Review

After hearing an appeal, the Board of Review must confirm, reduce, increase or annul the Commissioner's tax assessment or, in some cases, remit the matter back to the Commissioner for reassessment.

If either the appellant or the Commissioner disagrees with a decision of the Board of Review he may apply to either the Court of First Instance or the Court of Appeal for leave to appeal against the Board's decision on a question of law.

Prior to 1 April 2016, in order to appeal a decision of the Board, the taxpayer or the Commissioner would have to make an application to the Board for it to state a case on a question of law arising from its decision. This would then be submitted to the court for its opinion.

The applicant would be required to prepare a draft case on the proposed question of law and then seek, as far as is possible, the agreement of the other party to the draft. Thereafter the applicant would submit the draft case to the Board of Review. The Board had the ultimate responsibility for

36. 18 IRBRD 591, paragraphs 42–48.

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stating the case and was not bound by the draft case submitted to it even if agreed to by the parties. Provided the Board was convinced that there existed a proper question of law, it would then state a case on the relevant questions of law for the opinion of the Court of First Instance or, in certain circumstances, the Court of Appeal. Where the Board was of the opinion that there was no proper question of law put forward by the appellant, it would refuse to state a case. Such decision could be challenged by either the taxpayer or the Commissioner through judicial review.

Both the taxpayer and the Commissioner could incur substantial legal expenses in reaching an agreement on the draft case stated under this procedure. Furthermore, this procedure was regarded as time-consuming and affected the capacity of the Board of Review to hear other appeals as it took, on average, six months for the Board to process a stated case before it could be heard in court.

The inefficiency of the case stated procedure arose in the case of Final Court of Appeal case of *Lee Yee Shing v CIR*[37] where McHugh NPJ raised the question whether cost, efficiency and the interests of justice would not be better served by abandoning the case stated procedure and substituting an appeal on questions of law. He noted that the case stated procedure creates delay, take up the time of the tribunals and parties and increases the expense of conducting litigation. While identifying some downsides (for example the cost of providing a transcript and the time spent by the court in determining what facts were found,) he felt that an appeal limited to questions of law was far more likely to further the interests of justice than the case stated procedure.

In 2015, legislation was passed to improve the current process of appealing a decision from the Board of Review.[38] This legislation became effective on 1 April 2016 and allows an appeal from the Board on a question of law to be heard by the Court of First Instance or the Court of Appeal without having to apply the case stated procedure.

Under the new appeal procedure, the Court of First Instance will grant leave to appeal if it is satisfied that such appeal involves a question of law and the appeal has a reasonable prospect of success or there is another reason why, in the interests of justice, the appeal should be heard.[39] It is the Court of First Instance, alone, that determines whether a question of law is involved or not.

37. [2008] 3 HKLRD 51; FACV 14/2007.
38. Inland Revenue (Amendment) (No. 3) Ordinance 2015.
39. Sec. 69(3)(e).

The criterion for the appellant to have a "reasonable prospect of success" before being granted leave to appeal requires that the appellant's grounds have merit and the case is reasonably arguable and ought to be heard, as opposed to grounds that are merely fanciful. The chance of success does not need to be probable: *King Global Investments v CIR*[40] and *CIR v Pang Fai*.[41]

If the Court of First Instance declines to grant leave to appeal, the appellant may approach the Court of Appeal and request such leave. Should leave be granted the matter will be referred back to the Court of First Instance.[42] However, where the Court of Appeal refuses to grant leave to appeal, the matter will be affectively concluded.

It will still be possible to conduct an appeal from the Board of Review directly to the Court of Appeal and bypass the Court of First Instance provided that leave to appeal the Board's decision has been granted by the Court of First Instance. In this situation, further leave to appeal must be granted by the Court of Appeal on the grounds that it is desirable by reason of the amount of tax in dispute or of general or public importance or if it is a particularly difficult matter or any other reason acceptable to the Court of Appeal.[43]

The new appeal procedure does not alter the fact that the Board of Review operates as a fact finding body and on appeal to either the Court of First Instance or the Court of Appeal no new evidence will, generally, be permitted. In addition, neither court will vary any conclusion made by the Board on questions of fact unless it finds that they are erroneous in law.

An application to appeal a decision from the Board of Review must be made in writing, stating the grounds of appeal and reasons why leave to appeal should be granted.[44] The opposing party may seek to quash the application by filing counter-arguments as to why leave to appeal should not be granted. The Court of First Instance may decide the application solely on written submissions of the two parties although it may on occasions conduct a hearing.

Sec. 69(1) specifically provides that an appeal to the Court of First Instance must be on a point of law, as the Board of Review is the final arbiter on questions of fact. For cases where the courts have dismissed

40. [2017] HKEC 232.
41. [2017] 1 HKLRD 1275.
42. Sec. 69(4).
43. Sec. 69A.
44. Sec. 69(3).

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appeals, under the former case stated regime, on the grounds that they did not concern any points of law, see *CIR v Asia Securities International Ltd*[45] and *Aust-Key Company Ltd v CIR*.[46] As to what constitutes a question of law, see the discussion in *CIR v Karsten Larssen & Co. (HK) Ltd*.[47] and the more recent Board of Review decision of *D26/05*.[48] In this latter decision, the Board of Review noted that a proper question of law was one which:—

(a) was a question of law;
(b) related to the decision sought to be appealed against;
(c) was arguable; and
(d) would not amount to an abuse of process if submitted to the court for consideration.

Although a case may not generally be appealed in respect of findings of fact by the Board of Review, if those findings are clearly unreasonable in light of the evidence presented this becomes a question of law on which a case may be stated. For example, in *CIR v Karsten Larssen & Co. (HK) Ltd.*,[49] the court noted that

"it is always a question of law whether the primary facts include any material upon which the conclusion could reasonably be found."

The more commonly quoted authority for the proposition, however, is the House of Lords judgement in *Edwards (Inspector of Taxes) v Bairstow & Anor*.[50] in which Lord Radcliffe stated:—

"it may be that the facts found are such that no person acting judicially and properly instructed as to the relevant law could have come to the determination under appeal. In those circumstances, too, the Court must intervene."

This principle has subsequently been widely adopted in Hong Kong. See, for example, the High Court decision in *CIR v Waylee Investments Ltd*.[51] where Barnett J noted:—

45. (1991) 3 HKTC 433.
46. [2001] 2 HKLRD 275.
47. (1951) 1 HKTC 11.
48. 20 IRBRD 174.
49. Ibid.
50. [1956] AC 14, [1955] 3 All ER 48, [1955] 36 TC 207.
51. (1990) 2 HKTC 483.

"the Court can set aside the decision of the Board only if it is clear that the Board have misunderstood the law and consequently misdirected themselves; or because their findings are perverse, that is to say, where the only true and reasonable conclusion contradicts the Board's findings."

In other words, the Board of Review has a duty imposed upon it to act reasonably in finding facts even though the IRO gives the Board extremely wide powers to accept or reject evidence and specifically provides that it is not bound by the legal rules of evidence (Sec. 68(7)).

Where leave to appeal has been granted, the Court of First Instance may, in deciding the appeal, confirm, reduce, increase or annul the assessment determined by the Board of Review, or remit the matter back to the Board with any directions (including a direction for a new hearing) that the court thinks fit.[52] The court, on hearing such an appeal on a point of law, may not receive any further evidence, or reverse or vary any conclusion made by the Board on questions of fact unless the court finds that such conclusion is erroneous in law.[53] Similarly, where the appeal from the Board has been "leapfrogged" to the Court of Appeal, the Court of Appeal may, under Sec. 69A confirm, reduce, increase or annul the assessment determined by the Board of Review, or remit the matter back to the Board with any directions (including a direction for a new hearing) that the court thinks fit. Furthermore, and similar to appeals to the Court of First Instance, the Court of Appeal may not receive any new evidence, or reverse or vary any conclusion made by the Board on questions of fact unless that conclusion is wrong in law.

The Court may also make any order which it sees fit in connection with the costs of the case. If the unsuccessful party disagrees with the decision of the Court of First Instance, he may appeal to the Court of Appeal and then to the Court of Final Appeal, subject to the *Supreme Court Ordinance*, the Rules of the Supreme Court and the Orders and Rules governing appeals to the Court of Final Appeal (Sec. 69(7)).

The cost of a Court hearing is inevitably high because of the necessity to employ legal representatives and this, plus the thought that the Commissioner's costs may have to be borne by the taxpayer if he is unsuccessful, are a sufficient deterrent to many taxpayers from taking their case beyond the Board of Review.

52. Sec. 69AA(1)(a).
53. Sec. 69AA(1)(b).

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10.3.3 Direct appeal to Court of Appeal

As has been discussed in Chapter 9.3.2, where a case has been determined by the Board of Review, either the appellant or the Commissioner may appeal direct to the Court of Appeal, thereby bypassing the Court of First-Instance, provided that the Court of Appeal grants leave for such an application.[54]

It is important to bear in mind that Sec. 69A provides that, only if a person has been granted leave to appeal to the Court of First Instance may they, with the leave of Court of Appeal, appeal directly to Court of Appeal (leapfrogging). If the Court of First Instance refuses to grant leave to appeal in the first place, but the Court of Appeal subsequently grants leave upon application by the taxpayer or the Commissioner, then another leave to appeal is still required from the Court of Appeal for leapfrogging the matter to the Court of Appeal. If the Court of Appeal then refuses to grant leave for leapfrogging the appeal, then the appeal from the Board of Review will be heard by the Court of First Instance.

Where the matter is of such importance that the unsuccessful party is likely to appeal from the Court of First Instance to the Court of Appeal, it makes sense from a cost and timing point of view to bypass the Court of First Instance using the leapfrogging mechanism.

10.3.4 Direct appeal to Court of First Instance

There are provisions whereby the Board of Review procedure can be bypassed and the Commissioner's determination of an objection submitted directly for determination by the Court of First Instance. This would not, of course, be a cost-saving measure but, where a point of considerable importance is at issue, it may be considered desirable to obtain a court opinion as soon as possible. Sec. 67 provide this opportunity. Because the Board of Review is intended to be the primary tribunal for finding facts and has broad powers to do so, however, it is not generally appropriate to appeal directly to the Court of First Instance unless the matter in dispute is largely a point of law and there is no material disagreement between the parties as to the facts of the case. A case cannot be referred direct to the Court of First Instance by either party without the consent of the other party. This is perhaps because the case may not have proceeded further than the Board of Review and, therefore, reference directly to the court introduces a substantial cost element.

54. Sec. 69A(1A) read with Sec. 69A(1) and Sec. 69(2).

The procedure can only be commenced after a notice of appeal has been given to the Board of Review as provided for in Sec. 66. Within 21 days after the date on which the notice of appeal is received by the Clerk to the Board of Review, or such further time as the Board may in any particular case permit upon application in writing by either party, the appellant or the Commissioner can give notice to the other party that he desires to transfer the appeal to the Court of First Instance. At the same time, the party giving such notice must send a copy to the Board of Review.[55]

If the party who receives such notice agrees to the transfer of the case to the Court of First Instance, he must give his consent in writing to the Board, and serve a copy on the other party, within 21 days after the date on which the notice was given, or such further time as the Board of Review may in any particular case permit upon application in writing by the person.

Obviously, if the party receiving the notice does not reply, the consent is not given and the appeal is not, therefore, transmitted to the Court of First Instance.

Upon receipt of a notice of consent, the Clerk to the Board to Review transmits the appeal to the Court of First Instance together with all documents submitted to the Board with the appeal.[56] So far as the Court is concerned, the case is then heard and determined in the same way as an appeal from a determination of the Commissioner.[57] The difference is that the Court becomes the fact finding body as well as giving an opinion on points of law. The matter could, indeed, be entirely factual with no point of law involved at all, although as noted above, it may not be appropriate to bypass the Board of Review in such circumstances.

Unlike an appeal to the Board of Review, once referred to the Court of First Instance, there is no automatic right of withdrawal of the appeal before the hearing; this can only be done with the specific consent of the court and subject to such costs as the court may determine.[58]

The following further rules apply to the appeal[59]:—

55. Secs. 67(1) and 67(2).
56. Sec. 67(3).
57. Sec. 67(4).
58. Sec. 67(6).
59. Sec. 67(5).

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(1) the court must give at least 14 days' notice to the parties of the date of the hearing, and may adjourn the hearing;
(2) the Commissioner is entitled to be heard at the hearing;
(3) as in an appeal to the Board of Review, the appellant cannot rely upon any grounds of appeal other than those contained in the notice of appeal, except with the leave of, and subject to the conditions of, the court;
(4) it is stated that the onus is upon the taxpayer to prove that the assessment is excessive or incorrect. There is authority in numerous UK cases, where there is a similar provision, for the view that the appeal is to be determined upon the balance of probability and that there is no automatic acceptance of the Commissioner's assessment until proved wrong; and
(5) The court may summon and examine any relevant witnesses.

In determining the appeal, the court can either increase, reduce or cancel the assessment or remit the case to the Commissioner to make appropriate adjustments. Also, the court can make whatever order as regards costs as it sees fit.[60]

10.3.5 Judicial review

Although the IRO contains a broad framework for objecting and appealing against an assessment, increasingly the legal process known as judicial review is being used by taxpayers who are dissatisfied with the actions of the Commissioner. Judicial review is a process by which a person can apply to a court for injunctive relief from the consequences of a decision of a public official. More commonly, judicial review cases involve reviewing the exercise of discretion by a public official, but can also extend to findings of fact by such an official which adversely impact upon the effect of a statutory provision on a person. As a matter of common law, a public official when exercising statutory discretion must act reasonably and properly take into account all relevant considerations and disregard irrelevant matters; failure to act in such a manner may give rise to a judicial review action.

A judicial review action can only be commenced with the leave of the court. Over the last two decades, the courts in the UK have demonstrated an increased willingness to allow such actions in tax cases. In Hong Kong, judicial review cases involving tax matters have also become more

60. Sec. 67(7).

common over that period, although it is not clear whether this reflects a greater willingness of the courts to allow such actions, or simply that taxpayers and their advisers have become more aware of the availability of this course of action. Although leave may be granted by a court to commence a judicial review action, this does not mean that the action will be successful. Indeed, the majority of decisions of the Hong Kong courts on such actions are in favour of the Commissioner. One reason for this is that, to be successful, the courts would generally need to be satisfied that the decision making process by the Commissioner was so flawed as to be clearly unreasonable and amount to an abuse of power or an act of bad faith, or that the reasoning (including the consideration of evidence) was not rational. In other words, generally the court will not just reconsider the decision on its merits, but will need to be satisfied that the decision making process was fundamentally flawed if the application is to be allowed.

One interesting question concerning judicial review is what is its role in tax matters given the extensive objection and appeal procedure provided for in the IRO. The answer to this is two-fold. First, some decisions (notably certain administrative decisions) are not subject to the objection and appeal procedures. Examples of such decisions include whether or not to grant an unconditional holdover of tax which is the subject of an objection,[61] and the refusal of the Board of Review to state a case for the opinion of the Court of First Instance under the previous appeal regime. Also, the refusal of the Commissioner to accept a late objection was the subject of (an unsuccessful) judicial review application. Interestingly, this case also involved a judicial review application of the Commissioner's decision to refuse to amend an assessment pursuant to Sec. 70A, although in line with the cases mentioned below, this was refused on the basis that the other avenues of appeal had not been exhausted.

Secondly, judicial review may be permitted in exceptional circumstances, most notably where there has been an abuse of power, notwithstanding the existence of an alternative mechanism for disputing an assessment. In other than these exceptional cases, however, the courts are generally reluctant to permit judicial review to be used as an alternative to

61. *Interasia Bag Manufactures Limited v CIR* (2004) 6 HKTC 655, [2004] 3 HKLRD 881; *CIR v Chia Tai Conti* [2005] 1 HKRC § 90-155; and *Nam Tai Trading* (2005) 7 HKTC 1, [2006] 2 HKLRD 459.

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the normal objection and appeal procedures.[62] In *Harley Development Inc. & Anor. v CIR*,[63] Lord Jauncey, delivering the judgement of the Privy Council, said: —

> *"Their Lordships consider that, where a statute lays down a comprehensive system of appeals procedures against administrative decisions, it will only be in exceptional circumstances, typically an abuse of power, that the courts will entertain an application for judicial review of a decision which has not been appealed."*

One Hong Kong case where the court held that there was an abuse of power which justified granting the judicial review application notwithstanding the existence of an alternative statutory objection and appeal procedure was *Lee Ma Loi v CIR*[64] which is discussed in section 9.2.1.

In *Yue Yuen Marketing Company Ltd v CIR*,[65] the taxpayers applied to the court by way of judicial review that assessments were unlawful on the grounds that: —

- the Commissioner abused her power by issuing "arbitrary" assessments. In issuing the assessments, the Commissioner raised tax on the whole of their profits without any apparent attempt to distinguish any part thereof as arising from activities carried out in Hong Kong, as opposed to manufacturing operations carried out elsewhere; and.
- the Commissioner failed in her duty under Sec. 64(2) to determine the objections "within a reasonable time." Such unreasonable delay had barred the taxpayer's recourse to the Board of Review.

The taxpayers went on to suggest bad faith on the part of the Commissioner as shown by (i) the unreasonable delay; and (ii) the demand to purchase Tax Reserve Certificates of significant amounts. Accordingly, the taxpayers asked that the assessments be quashed.

The court declined to quash the assessments as it could not conclude that there had been an abuse of power. The court considered it inappropriate to make a ruling of abuse of power on the basis of the correctness of the assessments because it would usurp the functions of the Commissioner and the Board. Rather, the court indicated that a ruling of abuse of power would have to rest on a consideration of whether there was an

62. *Asia Master Limited v CIR* (2006) 7 HKTC 25.

63. [1996] 2 HKLRD 147.

64. (1992) 3 HKTC 659.

65. [2012] 4 HKLRD 761.

abuse in the procedure followed in making the assessments. The taxpayer's argument ultimately turned on an allegation of bad faith by the Commissioner. The court did not infer bad faith from the apparent delay and the significant amount of Tax Reserve Certificates involved. The former could be caused by a combination of valid and invalid reasons, whilst the latter was "an inevitable consequence of the taxpayers' sizable manufacturing profits which the Commissioner perceives as potentially Hong Kong sourced."

However, the court found an inordinate delay by the Commissioner in making its determination on the objections because: —

- Six years had lapsed since the issuance of the protective assessment for 1997/98
- The six year delay cannot be entirely attributed to the taxpayers' faults / slow responses
- For subsequent years, the same tax analysis should apply as there has been no significant change in the Taxpayers' mode of operation.

In view of the finding of an inordinate delay, the Court made the following orders: —

- An order of mandamus—the Commissioner to determine the objections within six months from the date of the judgment
- An order nisi—the Commissioner to bear 75 percent of the taxpayers' costs of the judicial review.

Kong Tai Shoes Manufacturing Company Ltd v CIR[66] sought a judicial review of the Commissioner's profits tax assessments on the basis that the assessments were ultra vires and should be quashed. In the alternative, the taxpayer sought an order of mandamus requiring the Commissioner to determine the taxpayer's objections to the assessments within a month and an order quashing the Commissioner's refusal to hold over the taxpayer's tax liabilities unconditionally pending the determination of its objections.

As of the date of the hearing, the Commissioner had not issued a determination in respect of any of the objections. Following the grant of leave to apply for judicial review in May 2011, the Commissioner stated that determinations would be issued for the 5 earlier years by a specified date. In relation to the 6 latter years, the Commissioner denied that there had

66. [2012] 4 HKLRD 780.

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