HCIA 10/2005

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE

INLAND REVENUE APPEAL NO. 10 OF 2005

BETWEEN

COMMISSIONER OF INLAND REVENUE Appellant

and

CHU FUNG CHEE Respondent

Before: Hon Chung J in Court
Date of Hearing: 14 February 2006
Date of Handing Down Judgment: 20 May 2006

J U D G M E N T

Introduction

1. This is a case stated brought pursuant to s. 69(1), Inland Revenue Ordinance (Cap. 112) the relevant part of which provides:-

> "… the appellant or the Commissioner [of Inland Revenue] may make an application requiring the Board to state a case on a question of law for the opinion of the Court of First Instance … ".

S. 69(5), Cap. 112 also provides:-

> "Any judge of the Court of First Instance shall hear and determine any question of law arising on the stated case and may in accordance with the decision of the court upon such question confirm, reduce, increase or annul the assessment determined by the Board, or may remit the case to the Board with the opinion of the court thereon. Where a case is so remitted by the court, the Board shall revise the assessment as the opinion of the court may require".

2. This application was commenced by the Commissioner of Inland Revenue ("*the Commissioner*") who contends a question of law, which the Board of Review ("*the Board*") determined on 2 June 2005 in favour of the appellant before the Board (who was the taxpayer, and the respondent in this case stated) ("*the taxpayer*"), should have been determined in the Commissioner' s favour.

3. The Board concluded that the payment by the taxpayer of costs ordered to be paid by the Bar Disciplinary Tribunal ("*the Tribunal*") were deductible expenses for the purpose of profits tax assessment.

4. The question of law posed in the case stated is:-

> "Whether, on the facts found, [the Board] erred in law in concluding that the payments of the costs of the Bar Council and [the Tribunal] by [the taxpayer] were deductible in computing his assessable profits".

Background Facts

5. The background facts giving rise to this case stated are undisputed.

6. The taxpayer was a practising barrister in Hong Kong since 1995. In the years of assessment (for profits tax) 2000/01 to 2001/02, the taxpayer paid to the Bar Association the following sums:-

(a) $342,122 (2000/01);
(b) $380,122 (2001/02);
(c) $32,000 (2002/03).

These were the costs of the Bar Council and the Tribunal incurred for the disciplinary proceedings brought against the taxpayer before the Tribunal in 2000.

7. I understand that the apparent discrepancies in the above dates can be explained by the dates set out in para. 6(a) to 6(c) above being the dates of actual payment. Further, the sums set out therein were rounded to the dollar.

8. The taxpayer faced a total of 10 disciplinary complaints during the disciplinary proceedings. 6 of the complaints were found proven against him. In short, they were:-

(1) when the taxpayer applied to the University of Hong Kong ("*HKU*") to take up a postgraduate studentship, he breached his oral undertaking given to an officer of HKU to the effect that he would cease practising as a barrister upon taking up the said studentship;

(2) the taxpayer signed a "Confirmation of Eligibility for Award of Postgraduate Studentship" confirming that he was not engaged in paid employment outside HKU when in fact he was practising as a barrister;

(3) the taxpayer had been dishonest in that he falsely misrepresented in his application documents submitted to HKU that his BA degree awarded by the University of Waterloo in 1982 was a first class honours degree.

Further to such findings, the Tribunal also ordered the taxpayer to pay the costs of the disciplinary proceedings mentioned in para. 6 above.

Relevant Statutory Provisions

9. The first relevant provision is s. 16(1), Cap. 112 which governs outgoings and expenses deductible for profits tax purposes:-

> "In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period … ".

10. S. 17(1), Cap. 112 stipulates what expenses are not deductible for profits tax purposes. S. 17(1)(a) to (c) are relevant:-

> "…

(a) domestic or private expenses …

(b) … any disbursements or expenses not being money expended for the purpose of producing such profits;

(c) any expenditure of a capital nature or any loss or withdrawal of capital … ".

11. Under s. 68(4), Cap. 112, the burden of proving the assessment is excessive or incorrect lies with the taxpayer.

12. Reliance is also placed on s. 37, Legal Practitioners' Ordinance (Cap. 159):-

"On completion of its inquiry, [the Tribunal] may do one or more of the following –

…

(e) order the barrister to pay a penalty not exceeding $500000, which shall be paid into the general revenue;

(f) order the barrister to pay the costs of and incidental to the proceedings of the Tribunal and the costs of any prior inquiry or investigation in relation to the matters before the Tribunal, to be taxed by a Master of the High Court on a full indemnity basis, or an amount that the Tribunal considers to be a reasonable contribution towards those costs … ".

The Commissioner's Case

13. The Commissioner contends that the Board erred in law in concluding that the costs paid by the taxpayer were deductible expenses for the following reasons:-

(a) the expenses must be incurred "in the production of profits" in order to be deductible, that is, they were incurred in profit-making activities. Merely because the expenses were connected to the taxpayer's trade, profession or business are insufficient;

(b) while the Board correctly decided that fines and penalties are generally not deductible expenses, it erred in concluding that, as a matter of construction of Cap. 159, the costs paid by the taxpayer were not in the nature of fines or penalties;

(c) insofar as the costs paid may be considered as expenses incurred "in the production of profits", they were in the nature of capital expenditure.

The Taxpayer's Case

14. The Commissioner's contention set out in para. 12(a) above is wrong. For expenses to be deductible, it is sufficient if they were incurred to enable the taxpayer to continue his trade, profession or business, or to resume the same. Reliance is placed on the decisions in *CIR v. Lo & Lo* (1983) 2 HKTC 34, 71; *CIR v. Swire Pacific Ltd.* (1979) 1 HKTC 1145, 1169-70; *The Herald and Weekly Times Ltd. v. The Federal Commissioner of Taxation* (1932) 48 CLR 113; *Morgan v. Tate & Lyle, Ltd.* [1954] 2 All ER 413; *MacKinlay v. Arthur Young McClelland Moores & Co.* [1988] 2 All ER 1.

15. As regards para. 12(b) above, the taxpayer argues that it is not the law that a penalty is not deductible expenses whereas costs are: *McKnight v. Sheppard* [1999] 3 All ER 491.

16. Finally, the costs paid were not capital expenditure.

(1) Were the Costs Incurred "in the production of profits"?

17. The following was what the Board said regarding this issue:-

> "From the facts of the case, it is apparent that the Relevant Costs were primarily incurred by [the taxpayer] for business purposes as [he] had to defend himself in the Disciplinary Proceedings ***to avoid the risks of being struck off or being suspended from practice***. By undertaking the defence, some private purposes … might have been served as well, such as the defence of his name. But … such private purpose has also a business purpose as 'name' or 'repute' is an important attribute of [the taxpayer's] professional calling … " (emphasis supplied) (para. 14, Board's decision);
>
> "On the subject of whether it is necessary for the [disciplinary] complaints … to have a ***close connection*** with [the taxpayer's] business as barrister … [it] was submitted by [the taxpayer] that the Bar Code has a wide ambit of governance on the conduct of its members …
>
> [The taxpayer] also put forward arguments … that in this case, there was ***in fact connection*** between his practice as a barrister and those actions taken by him which led to the complaints. In particular, [the taxpayer] submitted that the oral undertaking held by [the Tribunal] to have been given by him … was in fact embodied in the telephone conversation held between the officer of [HKU] and [the taxpayer] (at his chambers). …

> … we consider it useful to briefly review the background circumstances as set out in the Statement of Findings of [the Tribunal]. We note that the main complaint was the alleged breach of an oral undertaking given by [the taxpayer] … that he would cease to practice as a barrister upon taking up a postgraduate studentship … [the taxpayer] did not admit that he had given an undertaking … He only admitted having a telephone conversation in which [the] subject of not accepting news cases and new briefs was discussed. So, ***in a way***, [the taxpayer] was ***defending on the basis that his practice as a barrister at the material time … did not amount to a breach of undertaking***, if any. This, in our view, showed that the Disciplinary Proceedings against the Appellant did have a substantial connection with his practice as a barrister and it is not necessary for us to rule whether the events leading to the Disciplinary Proceedings were relevant … " (para. 16, 18 and 19, Board's decision).

18. I agree with the Commissioner and disagree with the taxpayer regarding this issue.

19. In *Strong & Co. v. Woodifield* [1906] AC 448, the House of Lords dealt with an appeal which concerned the Third Rule, Schedule D, Income Tax Act 1842, which contained the phrase "for the purposes of the trade". The taxpayer in *Woodifield* claimed that damages and costs paid were deductible. The court said:-

> "In my opinion, however, it does not follow that if a loss is in any sense connected with the trade, it must always be allowed as a deduction; for it may be only remotely connected with the trade, ... I think only such losses can be deducted as are ***connected with in the sense that they are really incidental to the trade itself***. They cannot be deducted if they are mainly incidental to some other vocation or fall on the trader in some character other than that of trader. The nature of the trade is to be considered" (emphasis supplied) (per Lord Loreburn, p. 452);
>
> "I think that the payment of these damages was not money expended ' for the purpose of the trade' . These words are used in other rules, and appear to me to mean for the purpose of enabling a person to carry on and earn profits in the trade, &c. I think the disbursements permitted are such as are made for that purpose. It is not enough that the disbursement is made in the course of, or arises out of, or is connected with, the trade, or is made out of the profits of the trade. It must be made ***for the purpose of earning the profits***" (emphasis supplied) (per Lord Davey, p. 453).

Thus, the degree of connection between the expenses and the profit-earning process of the trade, profession or business is important (see also para. 29 below) and must satisfy the tests of being "really incidental to the trade itself" or having been incurred "for the purpose of earning the profits".

20. Although the wordings in the English tax statutes were different from that in our s. 16(1), Cap. 112, the Privy Council said in *CIR v. Cosmotron Manufacturing Co. Ltd.* [1997] HKLRD 1161 (on appeal from Hong Kong):-

> "… [Liu, JA] regarded the words 'in the production of profits' as having a much narrower ambit than the words 'for the purposes of the trade' which appear in the Income and Corporation Taxes Act 1988.
>
> The difference in language is undeniable, but the phrase used in the United Kingdom legislation has generally been interpreted by the courts in a manner, consistent with that of the Inland Revenue Ordinance. Thus in [*Woodifield*], Lord Davey said: [the above passage was quoted]" (p. 1167).

In short, therefore, the two phrases were considered to have the same meaning.

21. In *CIR v. Tai Hing Cotton Mill (Development) Ltd.*, HCIA 8/2004, the test adopted for determining this point was expressed as:-

> "It is the nature of the payment that matters. 'It is necessary to … attend to the true nature of the expenditure, and to ask oneself the question, … is it expenditure laid out as part of the process of profit earning?" (para. 94).

I consider the court in *Tai Hing Cotton Mill* to be stating the same tests propounded in *Woodifield* in a different way.

22. The disciplinary proceedings concerned the taxpayer's dealings with HKU when the taxpayer applied for postgraduate studentship. That application (and the studentship) (as the parties appear to have accepted in the case stated (as when they appeared before the Board)) has nothing to do with his practice as a barrister.

23. The only way in which the disciplinary proceedings can relate to the taxpayer's practice as a barrister is that, if the charges were found proven, this can result in the cessation of the taxpayer's practice (either permanently or temporarily). The Board must have approached the matter from such a perspective in para. 14, Board's decision (quoted above).

24. Under the heading "(3) Were the Costs a Capital Expenditure?", I will discuss whether payment of the costs ordered against the taxpayer in order to preserve his practice is capital in nature. But if that matter is left aside, para. 14, Board's decision has completely failed to apply the tests propounded in *Woodifield* (and repeated in different language in *Tai Hing Cotton Mill*).

25. I now turn to para. 16 and 18, Board's decision (also quoted above). From the way in which the matter was recited there by the Board, it appears that the taxpayer also accepted there had to be a close connection between the costs he was ordered to paid and the profit-earning activities before the payment can be deductible for profit-tax purposes. It is unclear if the Board adopted the same approach in reaching its conclusion that the payment was deductible (at para. 19, Board's decision).

26. Insofar as the Board in fact adopted the tests propounded in *Woodifield* to conclude that:-

> "… in a way, [the taxpayer] was defending on the basis that his practice of a barrister at the material time … did not amount to a breach of undertaking, if any. This, in our view, showed that the Disciplinary Proceedings were relevant … "

(because there was a close connection with the costs paid and the profit-earning activities), the conclusion totally lacked evidential basis and is in that sense perverse. Insofar as the Board did not adopt those tests, it erred in failing to do so.

27. The authorities relied on by the taxpayer cannot advance his case because, when properly understood, they involved different issues.

28. The decision in *Lo & Lo* was about whether tax deductions could be made when the liability to pay was accrued but actually payment has not yet been made (actual payment would have to be made in future). Hence, the Privy Council said:-

> "… ' an expense incurred' is not confined to a disbursement, and must at least include a sum which there is an obligation to pay, that is to say an accrued liability which is undischarged" (p. 72).

29. The decision in *Swire Pacific Ltd.* was about the employer's cash payment to the whole of its labour force, which went on strike, to end the strike. The payment was found to be revenue in nature. The finding is readily understandable because, on the facts, the employer's business could not operate without its labour force; further, the employer's payment was in effect to discharge its liability (which was already incurred) to pay retirement grants in future.

30. The taxpayer in *The Herald and Weekly Times Ltd.* was the proprietor and publisher of an evening newspaper. In deciding that the compensation payment it made was deductible expenses, the Australian court said:-

> "None of the libels or supposed libels was published with any other object in view than the sale of the newspaper. The liability to damages was incurred … because of the very act of publishing the newspaper.

> … The distinction between such a case as the present and *Strong & Co. v. Woodifield* … lies in the ***degree of connection*** between the trade or business carried on and the cause of the liability for damages" (emphasis supplied) (pp. 118-9).

31. In *Morgan v. Tate & Lyle*, the court allowed advertising expenses incurred by the taxpayer to prevent the seizure of its business to be deducted from tax assessment. The inland revenue argued that the business would continue although its owner might be different. The court said:-

> "A general test is whether the money was spent by the person assessed in his capacity of trader or in some other capacity … It is said that the [inland revenue] can succeed in this case on an application of that test because a distinction must be recognised between a person as trader and the same person as owner of his trade. I find that distinction difficult to understand. … I do not see how a person can be owner of the trade unless he is also the trader, or how he can be the trader unless he is also the owner of the trade … " (pp. 431-2).

32. The decision in *MacKinlay* was concerned with whether relocation expenses paid by a firm of accountants to its employees and partners were deductible. The dispute was whether such expenses, when incurred by a large partnership business, were different from expenses incurred by a sole practitioner. The court, in agreeing with the taxpayer, said:-

> "The authorities show clearly that … (1) a partnership is to be treated as an entity separate from the partners …, (2) it is accordingly possible for a partnership to incur an expense which is deductible in ascertaining the firm's profits, even though the recipient is one of its own members …
>
> Thus, unless the taxpayer and the person benefiting from the expenditure be the same person, it is the object of the taxpayer in making the expenditure, rather than that of the beneficiary in receiving it, which has to be ascertained" (pp. 11-2).

(2) Should the Costs be Deductible?

33. This is related to the Commissioner's contention that the costs ordered by the Tribunal should be regarded as in the nature of a fine or penalty.

34. I consider several matters to be important. First, the costs ordered to be paid by taxpayer were not his own costs for defending the disciplinary proceedings; they were the costs of the Bar Council and the Tribunal.

35. Secondly, as the Commissioner correctly points out, the powers exercised by the Tribunal when ordering the taxpayer to pay costs were founded on s. 37, Cap. 159 (see para. 11 above) and not on s. 36(8), Cap. 159:-

> "[The Tribunal] may make such order as to the payment by a party to an inquiry of the costs incurred in conducting the inquiry as it thinks just".

I agree with the Commissioner that the costs ordered under s. 37 are akin to a fine or penalty whereas those ordered under s. 36(8) are intended to indemnify.

36. There is a further matter indicating that the costs should not be deductible expenses. The relevant parts of s. 39(1), Cap.159 provide:-

> "The expenses incurred by … [the Tribunal] … and … the Bar Council, in connection with proceedings before [the Tribunal] … may be paid to the Bar Council out of general revenue upon a certificate issued by the Secretary for Justice".

S. 39(2) lays down the conditions for issuing such a certificate one of which is:-

> "The Secretary for Justice shall only issue a certificate under subsection (1) if he is satisfied that … the expenses could not reasonably be recovered from the barrister whose conduct is the subject of the proceedings before [the Tribunal] … ".

Cap. 159 therefore clearly intends that the expenses should be recovered from the barrister first, before seeking payment out of the general revenue.

37. This legislative intention is similar to one of the reasons given in *McKnight v. Sheppard* for refusing to allow expenses in the nature of a fine or penalty to be deductible:-

> "… the legislative policy would be diluted if the taxpayer were allowed to share the burden with the rest of the community by a deduction for the purposes of tax": at p. 496b-d.

38. Not only did the Board fail to correctly consider the above, it wrongly took into account s. 15(a), Costs in Criminal Cases Ordinance (Cap. 492) which, as the name of the statute implies, is concerned with the nature of costs awarded in criminal proceedings (which disciplinary proceedings are not).

(3) Were the Costs a Capital Expenditure?

39. Having concluded in the Commissioner' s favour that the costs paid are not deductible expenses, it is strictly unnecessary to deal with this issue. I shall do so for completeness. This issue can be dealt with briefly in view of the matters set out above, especially those at para. 21 and 22 above.

40. I agree with the Commissioner that, on the facts found by the Board, the costs ordered to be paid by him can only be for the purpose of preserving his practice as a barrister, and were hence capital expenditure (which is not deductible under s. 17(1)(c), Cap. 112). I also agree with the Commissioner that the applicable test is that laid down in *Sun Newspapers Ltd. v. The Federal Commissioner of Taxation* (1939) 61 CLR 337:-

> "There are … three matters to be considered, (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its used or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment" (p. 363).

(See also *British Insulated and Helsby Cables v. Atherton* [R926] AC 205, 213-4; *Regent Oil Co. Ltd. v. Strick* [1966] AC 295, 312-3).

41. The Board' s conclusion that the costs were not capital expenditure but were revenue in nature appears to be tied to its conclusion at para. 19, Board' s decision: see para. 23, Board' s decision. I have already found that the Board erred in that part (as well as the other parts referred to above) of its decision. This conclusion of the Board cannot stand either.

42. The Board considered that whether the costs were capital expenditure should also depend on the seriousness of the disciplinary charges against the taxpayer: see para. 23, Board' s decision. The Board remarked in its decision:-

> "… we think it is necessary to take into account the nature and seriousness of the offence(s) or complaint(s) in question because it is important to distinguish between defending the existence of a structural asset and defending peripheral damage to or short-term disability of such structural asset " (para. 25, Board' s decision).

With respect, on the facts of this case, the Board' s approach is simply wrong.

Conclusion

43. Parts of the Commissioner's complaint in this case stated are related to findings of the Board which are at least partly factual. I agree with the Commissioner that the complaint is apt because the errors in the findings are:

(1) based on misdirections of law;
(2) unsupported by evidence; and/or
(3) improper inferences drawn from the primary facts.

(*CIR v. Inland Revenue Board of Review and Another* [1989] 2 HKLR 40, 54, 56-7; *Kwong Mile Services Ltd. v CIR* (2004) 7 HKCFAR 275, para. 31-35).

44. The question posed in the case stated is answered in the affirmative. The Board's assessment (setting aside the Commissioner's assessments for the years 2000/01 and 2001/02) is annulled.

Costs Order

45. I have heard the parties' submissions regarding the costs of the case stated. There is no sufficient reason to depart from the usual rule that costs should follow the event. There will accordingly be a costs order that those costs be paid by the taxpayer to the Commissioner to be taxed if not agreed.

(Andrew Chung)
Judge of the Court of First Instance
High Court

Ms Yvonne Cheng of Secretary for Justice, for the Appellant

Respondent (Chu Fung Chee) acts in person and present