Case No. D46/13

Profits tax – appellant claiming ex-gratia payment not subject to profits tax – function of Grounds of Appeal – Board's role on appeal – whether payment chargeable to profits tax – whether profits arising in or derived from Hong Kong from such trade, profession or business – sections 14, 66(3), 68(4) and 68(7) of the Inland Revenue Ordinance (Chapter 112) ('IRO').

Panel: Kenneth Kwok Hing Wai SC (chairman), Julia Pui-g Lau and Christina W W Lee.

Date of hearing: 19 October 2010.
Date of decision: 17 March 2014.

The Appellant carried on business of, *inter alia*, provision of insurance agency service ('Business') under the name of his firm, Company A. By two agreements in 1994 and 1995, the Appellant was appointed as 'agent' and 'manager' of Company B, which later changed its name to Company C2 in 2007. Company C2 later filed a notification of remuneration paid to persons other than employees for the financial year 2007/08 in respect of the Appellant, reporting an income of around $26.7 million. The Appellant filed his tax return for the financial year, in which he, *inter alia*, declared assessable profits from Company A of around $23 million (which included income reported by Company C2). The Appellant further attached a letter declaring that: (a) he had received an amount of $30 million ('Sum') during the financial year from Company D, which was a holding company of Company E; (b) during the financial year, Company D sold Company E to Company C2's group at a high return, and the Sum was distributed to the Appellant by Company D; (c) the Appellant did not report the Sum in his individual tax return as it was not chargeable to profits tax. The Appellant also produced a letter issued by the deputy chairman of Company D to him with a view to support his contention.

The Assessor took the view that the Sum was income deriving from the Business and was chargeable to profits tax. The Appellant objected to the assessments on the ground that the profits assessed were excessive as the Sum should not be chargeable to profits tax. The Appellant further alleged that: (a) the Appellant had no business relationship with Company D; (b) the Sum was distribution of capital gain on disposal of Company E by Company D, and did not arise from day to day operation of the Business with Company E; (c) the Sum was not paid to him as reward of his role as agency leader, instead it was profit arising from the sale of capital assets of the Business.

Further, Company D also provided the following information: (a) the Appellant was an agency leader of Company E's group. Company E never had contractual relationship with the Appellant; (b) Company D made a significant gain on the sale of Company E's group,

which might not have been completed successfully without the Appellant's concurrence; (c) the Appellant was not contracted by Company D to sell Company E's group, but the success and valuation of Company E's group was owed to its loyal and capable managements and agents; (d) the Sum was not determined based on any formula.

The Assessor maintained the assessment, which the Appellant refused to accept. The Appellant appealed against the assessment, claiming, in the grounds of appeal, that: (1) the Appellant provided insurance agency and managerial services to Company E and received commission and gratuities in return. All income generated had been reported under profits tax; (2) the Appellant did not perform any services to Company D, and the sum received from Company D was merely a distribution of its gain on disposal of Company E and should not be regarded as income generated from the Business.

Held:

1. The grounds of appeal governed the scope of the admissible evidence and defined the issues on appeal. Unless permitted by the Board, the appeal was confined to the original grounds of appeal. Application for the Board's consent to amend the grounds of appeal 'should be sought fairly, squarely and unambiguously'. (China Map Limited v CIR (2008) 11 HKCFAR 486 considered)

2. The Appellant bore the burden of proving that the assessment was excessive or incorrect. The Board must consider the matter from the beginning anew, and perform its 'ultimate function' to 'confirm, reduce, increase or annul the assessment' appealed against. On appeal, the Board was the only fact finding body and decision-maker. The Appellant's contention that he maintained the view that the Sum was not subject to profits tax was not helpful. The Appellant's view was simply irrelevant to whether the Sum was chargeable to profits tax. The issue was governed by statute. (Shui On Credit Company Limited v Commissioner of Inland Revenue (2009) 12 HKCFAR 392 and Commissioner of Inland Revenue v Nina T H Wang [1993] 1 HKLR 7 considered)

3. The Appellant's contention in ground (1) was beside the point. The issue was whether the Sum was chargeable, not whether other sums reported were chargeable. The contention in (1) disclosed no arguable ground of appeal.

4. Insofar as the Appellant's contention in ground (2) was concerned, there was no evidence that the Sum was merely a distribution of Company D's gain on disposal of Company E. Chargeability did not depend on whether the Appellant had performed any service to Company D. Instead, it was governed by statute and the issue was whether the Sum was 'profits arising in or derived from Hong Kong for that year from such trade, profession or business'. The

Sum arose from the Business, as confirmed by the contemporaneous letter issued by or on behalf of Company D to the Appellant.

Appeal dismissed.

Cases referred to:

China Map Limited v CIR (2008) 11 HKCFAR 486
Shui On Credit Company Limited v Commissioner of Inland Revenue (2009) 12 HKCFAR 392
Commissioner of Inland Revenue v Nina T H Wang [1993] 1 HKLR 7

Denis K L Yeung of Lam & Chui CPA Limited for the Appellant.
Paul Leung, Counsel instructed by Department of Justice for the Commissioner of Inland Revenue.

Decision:

Introduction

1. The Assessor took the view that a one-off sum of $30,000,000 received by the Appellant in the year of assessment 2007/08 was chargeable to profits tax.

2. By a Determination dated 22 March 2010, the Acting Deputy Commissioner of Inland Revenue confirmed:

(a) Profits Tax Assessment for the year of assessment 2007/08, dated 15 January 2009, showing assessable profits of $53,005,210; and

(b) Personal Assessment for the year of assessment 2007/08 dated 15 January 2009, showing reduced total income of $53,011,872 with tax payable thereon of $8,456,899 (after deducting tax reduction);

((a) and (b) are hereafter collectively referred to as 'the Assessments').

3. The Appellant appealed from the Determination.

The agreed facts

4. The parties agreed the facts as stated in paragraphs 1(1) to (12) of the Determination under 'Facts upon which the Determination was arrived at' and we find them as facts as set out in paragraphs 5 to 16 below.

5. The Appellant has objected to the Profits Tax Assessment and Personal Assessment for the year of assessment 2007/08 raised on him. The Appellant claims that an ex-gratia payment received by him was not income generated from his business and should not be chargeable to profits tax.

6. At all relevant times, the Appellant carried on business under the name of [Company A]. Company A's business included, among others, the provision of insurance agency service ('the Insurance Agency Business').

7. (a) By an agent's contract for selling long term insurance business dated 21 February 1994 ('the 1994 Agreement'), the Appellant was appointed as 'agent' of Company B.

(b) By an agency general manager's contract dated 1 February 1995 ('the 1995 Agreement'), the Appellant was appointed as 'manager' of Company B to recruit, train and supervise agents for Company A.

8. Company B changed its name to Company C1 on 15 May 1999 and then to Company C2 on 7 August 2007.

9. Company C2 filed a notification of remuneration paid to persons other than employees for the year ended 31 March 2008 in respect of the Appellant reporting the following particulars:

(a)	Capacity engaged	:	Executive Company D Director
(b)	Period	:	1.4.2007 to 31.3.2008
(c)	Income particulars:		$
	Commission	:	17,315,268
	Gratuities	:	9,400,547
	Total	:	26,715,815

10. The Appellant filed his Tax Return – Individuals for the year of assessment 2007/08 in which he, among other things,

(a) declared the following income particulars:

	$	
Properties - assessable value	1,393,017	
Company A – assessable profits	23,005,210	[Note 1]

[Note 1] In arriving at the assessable profits, the Appellant had included the income reported by Company C2 at Paragraph 9(c).

(b) claimed for deduction for interest payments to produce rental income from properties in the total amount of $1,188,771.96;

(c) claimed for deduction for home loan interest in the amount of $358,693.22;

(d) elected for Personal Assessment; and

(e) claimed for married person's allowance and child allowance in respect of his three children.

11. (a) The Appellant attached a letter in his return declaring the following:

'I would like to report that I received an amount of HK$30 million ['the Sum'] during the year of assessment 2007/08. The amount was paid by [Company D], which was a holding company of [Company E] and is listed in [name of country omitted here]. During the year of assessment 2007/08, [Company D] sold its subsidiary [Company E] to [Company C2 Group] at a very high return. It then distributed HK$30 million to me … It is not reported in my individual tax return as it is not chargeable under profits tax.'

(b) The Appellant also provided a copy of letter dated 20 July 2007 issued by the Deputy Chairman of Company D under the letterhead of Company D to him ('the Letter'). The Letter reads as follows:

'… The sale of [Company E] to [Company C2] has achieved a very high return for [Company D] …

The success of [Company E] is owed to its very loyal and capable management and agents … Your role as agency leader has been particularly important as you gave your team great leadership and instilled a sense of loyalty to Company A and a desire to see Company A succeed. I recognize and appreciate that you excel in your role as agency leader not because it is your job but because you believe in your team and that their commitment to excellence will drive Company A's success.

Your dedication is something that is difficult to value in money terms. Nevertheless, [Company D] would like to extend to you an [ex-gratia] payment of HK$30 million, which will be credited to your bank account on July 26, 2007. We hope you will accept this as a token of our appreciation.'

12. The Assessor was of the view that the Sum was income deriving from the Insurance Agency Business and was chargeable to profits tax. Accordingly, she raised on the Appellant the following Profits Tax Assessment and Personal Assessment for the year of assessment 2007/08:

(a) Profits Tax Assessment

	$	
Assessable profits	53,005,210	[Note 2]
Assessable profits transferred to Personal Assessment	53,005,210	

[Note 2] Assessable profits
= $23,005,210 [paragraph 10(a)]
+ $30,000,000 (i.e. the Sum)

(b) Personal Assessment

	$	$
Income -		
Properties		1,114,413
Business [paragraph 12(a)]		53,005,210
Total income		54,119,623
Less: Deductions -		
Interest payable for letting properties	1,007,751	
Home loan interest	100,000	1,107,751
Reduced total income		53,011,872
Tax payable thereon (after tax reduction)		8,456,899

13. The Appellant, through Company F, objected to the Profits Tax Assessment and Personal Assessment in paragraph 12 on the ground that the profits assessed were excessive as the Sum should not be chargeable to tax. Company F put forth the following contentions:

(a) '… [the Sum] was distributed by [Company D] upon the disposal of its subsidiary, [Company E] to [Company C2 Group]. [Company D] is a listed company in [name of country omitted here]. [The Appellant] does not have business relationship with it. The receipt is the distribution of capital gain on disposal of [Company E] by [Company D]. It is not arising from day to day operation of his insurance agency business with [Company E]. Hence it is not chargeable under profits tax.'

(b) '[The Appellant] does not agree that [the Sum] was paid to him as a reward of his role as an agency leader although he received the appreciation in [the Letter] from the Deputy Chairman of [Company D].

> Instead it was only a distribution of capital gain on disposal of [Company E] by [Company D] and capital gain arising from the sale of his business from [Company E] to [Company C2]. It should not be regarded as his profits arising in or derived from Hong Kong for the year from his business. Hence it should be excluded from the assessable profits as it was profit arising from the sale of capital assets of his business.'

14. In response to the Assessor's enquiries, Company D provided the following information in respect of the circumstances leading to the payment of the Sum:

(a) The Appellant was an agency leader of the Company E group and provided insurance agency services to the group. Company D never had any contractual relationship with the Appellant.

(b) Company D is a [name of country omitted here] listed company. It used to own approximately 47% of the shares in Company E. On 15 May 2007, Company D completed the sale of its entire shareholding in Company E to Company C2.

(c) '[Company D] made a significant gain of approximately HK$2,596 million on the sale of [Company E group]. The sale might not have been completed successfully without [the Appellant's] concurrence. It is recognised that the agency force is a major asset of [Company E group] and that under [the Appellant's] leadership, his substantial agency force remained stable and intact from the date of signing of the Sale & Purchase Agreement ["the Agreement"] through to the Completion date, thereby ensuring one of the major factors which could have triggered the "material adverse change" condition precedent in the Agreement did not happen.'

(d) '[The Appellant] was not contracted by [Company D] to sell [Company E group]. Nonetheless, [Company D] recognises that the success of [Company E group] and the extremely attractive valuation of [Company E group] … is owed to its loyal and capable management and agents. In particular, [Company D] recognises that [the Appellant], as an agency leader, provided great leadership and instilled a sense of loyalty to the [Company E group] amongst the agents under his charge, without which many agents might have become concerned and destabilised by the impending sale of this business and might have elected to leave the [Company E group]. Accordingly, such an exodus would have constituted a breach of the Agreement and derailed the sale.'

(e) 'The ex-gratia payment was not determined based on any prior-agreed formula. [Company D] made a gain of approximately HK$2.6 billion on the sale of [Company E] and 1% thereof is approximately HK$26

million. This amount is round off to arrive at the sum of HK$30 million [i.e. the Sum].'

(f) '[Company D] arranged for [the Sum] to be credited to the Appellant's bank account in Hong Kong on 26 July 2007.'

15. The Assessor maintained the view that the Sum was income from the Insurance Agency Business and chargeable to profits tax. She wrote to the Appellant explaining her view and inviting the Appellant to withdraw the objection.

16. The Appellant declined to withdraw his objection. In response, Company F, on behalf of the Appellant, put forth the following arguments:

' [The Appellant] does not agree that [the Sum] was paid to him as a reward of his role as an agency leader. Instead the recognition of his excellence service provided to [Company E] as an agency leader was rewarded as substantial commission and gratuities which has been reported in I.R.56M … and his individual tax return. From the date of signing of the Sale and Purchase Agreement through to the Completion date, there was no instruction from [Company D] that he should maintain the stability of his agency in order to avoid adverse change which might constitute a breach of the sale. In addition, there was no agreement with [Company D] that he would receive extra payment after the successful sale. The amount was only a distribution of capital gain on disposal of [Company E] by [Company D] and was not the income generated from the business. It should not be regarded as his profits arising in or derived from Hong Kong for the year from his business …'

Grounds of appeal

17. By letter dated 19 April 2010, Company F gave notice of appeal on behalf of the Appellant on the following grounds (written exactly as it stands in the original):-

' Our client maintains the view that the amount of HK$30 million ['the Sum'] received from [Company D] is not subject to profits tax on the following grounds:

1. Our client provided insurance agency and managerial services to [Company E] and received commission and gratuities in return. All the income generated had been reported under profits tax.

2. Our client did not perform any services to [Company D]. The Sum received from it is merely a distribution of its gain on disposal of [Company E] and should not be regarded as income generated from the insurance agency business.'

The importance of the grounds of appeal

18. The grounds of appeal govern the scope of the admissible evidence and they define the issues on appeal, sections 68(7) and 66(3) of Inland Revenue Ordinance, Chapter 112.

19. Unless permitted by the Board under section 66(3), the Appeal is confined to the original grounds of appeal and applications for the Board's consent to amend the grounds of appeal 'should be sought fairly, squarely and unambiguously'[1].

> ' *9. By its representative, each of the Taxpayers put forward the grounds of appeal that the profits in question "were capital in nature and were not assessable to Profits Tax or alternatively that the assessment was excessive". None of the Taxpayers pursued its alternative ground that the assessments were excessive. That left only one question raised by the grounds of appeal given in accordance with s.66(1). Did the profits in question arise from the sale of capital assets? But at the hearing before us, Mr Patrick Fung SC for the Taxpayers contended that there was an antecedent question. Were the profits in question from the carrying on of a trade, profession or business?*
>
> *10. No such question is raised by the Taxpayers' grounds of appeal given in accordance with s.66(1). But Mr Fung contended that the Board is to be treated as having consented under s.66(3) to the Taxpayers relying on a fresh ground which raised such a question. For this contention, Mr Fung relied on an exchange between the Board's chairman and the Taxpayers' counsel (not Mr Fung or his junior Ms Catrina Lam). That exchange took place after the close of the evidence and during final speech. By its nature, such a question is fact-sensitive and its answer inherently dependent on evidence. For a tribunal of fact to entertain such a question after the close of the evidence would be unusual and plainly inappropriate if done without offering the party against whom the question is raised an opportunity to call further evidence. No such opportunity was offered to the Revenue. We do not think that the Board is to be treated as having consented under s.66(3) to the Taxpayers relying on a fresh ground which raised the antecedent question for which*
>
> *Mr Fung now contends. If and whenever s.66(3) consent is sought, it should be sought fairly, squarely and unambiguously. Nothing of that kind occurred in this case.*'

20. Section 66(3) was among the authorities cited by Mr Paul Leung, counsel for the Respondent. The panel chairman mentioned the China Map case. Mr Denis K L Yeung made no application to amend the grounds of appeal.

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[1] See China Map Limited v CIR (2008) 11 HKCFAR 486 at paragraphs 9 and 10.

Onus of proof

21. Section 68(4) provides that the '*onus of proving that the assessment appealed against is excessive or incorrect shall be on the Appellant*'.

Tax appeal is against an assessment

22. Hong Kong's appellate courts have held that the Board must:

(1) consider the matter from the beginning, anew; and

(2) perform its 'ultimate function' to 'confirm, reduce, increase or annul the assessment' appealed against.

(a) In Shui On Credit Company Limited v Commissioner of Inland Revenue, (2009) 12 HKCFAR 392, Lord Walker NPJ said in the Court of Final Appeal judgment at paragraphs 29 and 30 that the Board's function is to consider the matter *de novo* (meaning starting from the beginning; anew) and the appeal is an appeal against an assessment:

'*29. As the Board correctly observed, by reference to the decisions in Mok Tsze Fung v. CIR [1962] HKLR 258 and (after the amendment of s.64 of the IRO) CIR v. The Hong Kong Bottlers Ltd [1970] HKLR 581, the Commissioner's function, once objections had been made by the taxpayer, was to make a general review of the correctness of the assessment. In Mok Tsze Fung v Commissioner of Inland Revenue, Mills-Owens J said at pp 274-275:*

> *"His duty is to review and revise the assessment and this, in my view, requires him to perform an original and administrative, not an appellate and judicial, function of considering what the proper assessment should be. He acts de novo, putting himself in the place of the Assessor, and forms, as it were, a second opinion in substitution for the opinion of the Assessor.*

30. Similarly the Board's function, on hearing an appeal under s.68, is to consider the matter de novo: CIR v. Board of Review ex parte Herald International Limited [1964] HKLR 224, 237. The taxpayer's appeal is from a determination (s.64(4)) but it is against an assessment (s.68(3) and (4)) ...'

(b) In Commissioner of Inland Revenue v Nina T H Wang [1993] 1 HKLR 7, CA, Fuad VP said at page 23 that the Board must perform its 'ultimate function' to 'confirm, reduce, increase or annul the assessment' appealed against.

23. On an appeal to the Board:

(1) The Board is the fact finding body.

(2) The Board, not the Commissioner, not the taxpayer, not the tax representative, is the decision maker.

Consideration of the grounds of appeal

24. The Board has said on a number of occasions that contentions similar to the Appellant's contention that '[our] client maintains the view that the amount of HK$30 million … is not subject to profits tax' is neither helpful to the taxpayer nor the Board. The Appellant's view is simply irrelevant to whether the Sum is chargeable to profits tax. Chargeability is governed by statute.

25. Section 14 is the charging provision on profits tax. Sub-section (1) provides that:

> ' *Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment ... on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.*'

26. The first ground of appeal contends that:

> ' Our client provided insurance agency and managerial services to [Company E] and received commission and gratuities in return. All the income generated had been reported under profits tax.'

27. This contention is quite beside the point. The issue is whether the Sum is chargeable, not whether other sums reported are chargeable. The Appeal is against the Assessments and the only component in issue is the Sum. The first ground of appeal discloses no arguable ground of appeal.

28. By the second ground of appeal, Company F contends that:

> ' Our client did not perform any services to [Company D]. The Sum received from it is merely a distribution of its gain on disposal of [Company E] and

should not be regarded as income generated from the insurance agency business.'

29. The Appellant did not call any witness to testify. There was no evidence that the Sum was 'merely a distribution of [Company D's] gain on disposal of [Company E]'. There was no factual basis for the contention.

30. Chargeability does not depend on whether the Appellant has performed any service to Company D.

31. Chargeability is governed by statute and the issue is whether the profits, i.e. the Sum, were:

' profits arising in or derived from Hong Kong for that year from such trade, profession or business.'

32. The contemporaneous letter dated 20 July 2007 issued by the Deputy Chairman of Company D under the letterhead of Company D to the Appellant[2] read as follows:

' … The sale of [Company E] to [Company C2] has achieved a very high return for [Company D] …

The success of [Company E] is owed to its very loyal and capable management and agents … Your role as agency leader has been particularly important as you gave your team great leadership and instilled a sense of loyalty to Company A and a desire to see Company A succeed. I recognize and appreciate that you excel in your role as agency leader not because it is your job but because you believe in your team and that their commitment to excellence will drive Company A's success.

Your dedication is something that is difficult to value in money terms. Nevertheless, [Company D] would like to extend to you an [ex-gratia] payment of HK$30 million, which will be credited to your bank account on July 26, 2007. We hope you will accept this as a token of our appreciation.'

33. The Letter explained why the Sum was to be paid and showed that the Sum arose from:

- The Appellant's role as agency leader;
- The Appellant having given his team great leadership and instilled a sense of loyalty to Company A and a desire to see Company A succeed.

[2] i.e. the Letter.

- The Appellant excelling in his role as agency leader;
- The Appellant's belief in his team and that their commitment to excellence will drive Company A's success.
- The Appellant's dedication.

34. We conclude that the Sum arose from the Appellant's trade, profession or business, i.e. the Insurance Agency Business.

35. For the reasons given above, the Appeal fails.

Disposition

36. We dismiss the Appeal and confirm the Assessments.