

Case No. D4/13

Profits tax – adverse costs order against the only equity partner in separate set of proceedings – whether deductible - Sections 16(1), 17(1) and 68(4) of the Inland Revenue Ordinance ('the IRO').

Panel: Chow Wai Shun (chairman), Chan Yue Chow and Lam Lai Kuen.

Date of hearing: 6 March 2013.

Date of decision: 24 April 2013.

The Appellant is a firm of solicitors. Mr A is one of the partners and the only equity partner of the Appellant.

The Solicitors Disciplinary Tribunal ('the Tribunal') and the Law Society of Hong Kong commenced in February 2001 an inquiry into Mr A's professional conduct.

Mr A commenced separate set of proceedings against the Tribunal. He was unsuccessful both before the Court of First Instance and the Court of Appeal and was ordered to pay the costs of the Tribunal (the 'Costs').

The Appellant seeks to deduct the Costs for the Year of Assessment 2004/05 contending that:

- 'concession' has been made by the Assessor allowing the legal expenses of the Appellant in the disciplinary and court proceedings;
- the other set of court proceedings was highly relevant to which a settlement was reached saving much further costs;
- the Costs are not akin to a fine or penalty which had been held not deductible in McKnight v Sheppard;
- the Costs are highly relevant to and closely connected with the Appellant's profit earning.

Held:

1. Unless the Costs were incurred by the Appellant in the production of its chargeable profits (and not being excluded in any way by section 17 of the

Ordinance), it would not be allowed.

2. A concession by the Assessor to allow the Appellant's own legal costs is after all just a concession.
3. The Board cannot see the required connection between the Appellant's business or profession and the separate set of proceedings, and hence the Costs.
4. The Costs were costs of the Tribunal in the separate set of proceedings, which the Court ordered against Mr A. Had the Costs been allowed, it would have meant that to be shared by the community. As such, the Costs are not deductible under McKnight v Sheppard even if they are not a fine or penalty.
5. The Appellant fails to establish how the separate set of proceedings might be relevant for the purpose of producing its chargeable profits.

Appeal dismissed.

Cases referred to:

CIR v Chu Fung Chee [2006] 2 HKLRD 718
Strong & Co v Woodfield [1906] AC 448
McKnight v Sheppard [1999] 1 WLR 1333

Taxpayer in person.

Yvonne Cheng Senior Counsel instructed by Leslie Shay, Government Counsel of the Department of Justice for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This is an appeal against the part of the determination of the Deputy Commissioner of Inland Revenue dated 5 September 2012 ('the Determination') in respect of profits tax assessment on the Appellant for the year of assessment 2004/05.
2. This is a dispute on a point of law. The Appellant did not call any witness.
3. The following facts were not disputed and we find them relevant facts to this appeal:

- (1) The Appellant commenced business as a firm of solicitors carrying on a legal practice in Hong Kong on 1 October 1997. Mr A has been one of the partners of the Appellant since its commencement of business. He is the precedent and the only equity partner of the Appellant.
- (2) The Solicitors Disciplinary Tribunal ('the Tribunal') and the Law Society of Hong Kong ('the Law Society') commenced in February 2001 an inquiry into certain aspects of Mr A's professional conduct.
- (3) Mr A made an application to the Tribunal for the inquiry to be made public but the Tribunal refused.
- (4) Mr A applied for judicial review of the Tribunal's ruling of not holding the inquiry in public. He was unsuccessful both before the Court of First Instance and the Court of Appeal. On both occasions, Mr A was ordered to pay the costs of the Tribunal which was represented by the Law Society. These two sets of costs, \$614,296 and \$675,225 respectively, comprise the amount which the Appellant seeks to deduct in the calculation of its assessable profits in this appeal (collectively 'the Costs').

The issue

4. The issue for us to decide is whether the Costs are deductible and are not otherwise prohibited from deduction for profits tax purposes under the Inland Revenue Ordinance ('the Ordinance').

The relevant statutory provisions

5. Section 16(1) of the Ordinance provides:

In ascertaining the profits in respect of which a person is chargeable to tax under this Part [IV] 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...

6. Section 17(1) of the Ordinance provides:

For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of –

...

(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...

7. Section 68(4) of the Ordinance provides that the onus of proof is on the Appellant to show that the assessment against which it appeals is excessive or incorrect.

Our analysis

8. To be deductible, the expenditure in question must have been incurred by the Appellant. In addition, it must have been incurred for the purpose of earning its chargeable profits. It is not enough for the expense to simply arise out of its trade, business or profession or otherwise be connected with that trade, business or profession. The Hong Kong court in CIR v Chu Fung Chee [2006] 2 HKLRD 718 adopted and approved the following extracts from Strong & Co v Woodfield [1906] AC 448:

‘ 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, or it may be connected with something else quite as much as or even more than with the trade. I think that only such losses can be deducted as are connected with it 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 trade. The nature of the trade is to be considered’ (per Lord Loreburn at 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, etc. 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.’ (per Lord Davey at page 453)

9. Furthermore, the expenditure must not have been excluded in any way by section 17 of the Ordinance.

10. Mr A, on behalf of the Appellant, contended that since the legal expenses of himself and the Appellant in his defence in the disciplinary and court proceedings were made allowable for deduction under the Determination, the subject matters of such proceedings had to have been considered to have satisfied the test of being incidental to the Appellant’s trade or having been incurred for the purpose of earning its profits (‘Reason 1’). Further or alternatively, Mr A argued that the judicial review proceeding and the related

appeal are incidental to and closely connected with the disciplinary proceedings and the outcome of which, if favourable, was expected to significantly improve his chances of success in the latter proceedings ('Reason 2'). Mr A also contended that the Costs, as part of the legal expenses of the defence of the disciplinary proceedings, are unlike any costs order of the Tribunal. As such, they are not akin to a fine or penalty which had been held not deductible in McKnight v Sheppard [1999] 1 WLR 1333 ('Reason 3'). The Costs are also not only for the purpose of preserving Mr A's practice as a solicitor but highly relevant to and closely connected with the Appellant's profit earning ('Reason 4'). In the course of elaborating his Reason 4, Mr A sought to distinguish its case from Chu Fung Chee where the relevant conduct of the barrister had nothing to do with his legal practice.

11. On the other hand, it is the Respondent's position that:

- (1) the Costs were not incurred in the production of the Appellant's profits;
- (2) further or alternatively, the Costs were not deductible under the principle in McKnight v Sheppard [1999] 1 WLR 1333;
- (3) further or alternatively, even if the Costs were incurred in the production of the Appellant's profits, they could only have been capital in nature and therefore not deductible.

12. In the course of arguing that the Costs were not incurred in the production of the Appellant's profits, Ms Cheng raised that the Costs were not even incurred by the Appellant. This was because, Ms Cheng said, the Costs were levied on Mr A personally, for which the Appellant had no liability to pay. The point was made on the basis of section 22(1) of the Ordinance, which reads:

'Where a trade, profession or business is carried on by 2 or more persons jointly the assessable profits therefrom shall be computed in one sum and the tax in respect thereof shall be charged in the partnership name.'

Mr A, in reply, relied on the fact that the Appellant's equity was entirely owned by one partner and that had been himself at all material times. As such, Mr A argued, they were the one and the only one single beneficial entity concerned.

13. We deal with the last point first. It seems to us only a side point and does not affect our decision in any way. While we take the point that the Appellant had no liability to pay the Costs, on evidence it did pay them. In the statutory language, it had incurred the Costs. To this extent, we do not agree with Ms Cheng. However, we cannot agree with Mr A either. It is clear that the Appellant and Mr A are not one single entity for the purposes of the Ordinance. We also think Ms Cheng was right in saying that the appropriate question to ask was the object to be served by the Appellant having paid (or, in the statutory language, incurred) the Costs. Unless the Costs were incurred by the Appellant in the production of its chargeable profits (and not being excluded in any way by section 17 of the Ordinance), it

would not be allowed to deduct the Costs.

14. Were the Costs incurred, to any extent, in the production of the Appellant's chargeable profits?

15. In Reason 1, relying on the 'concession' made by the Assessor under the Determination, which allowed the deduction of the legal expenses of, inter alia, the Appellant in his conduct of the disciplinary and court proceedings, Mr A argued that the subject matters had to have been considered to have satisfied the test. We do not agree; instead, as Ms Cheng correctly reminded us, we need come to our own view. In fact, we could even consider the matter *de novo*. Ms Cheng also pointed out in answering one of our questions, that the concession was taken from a proposal for settlement of the dispute which was made on the basis that the Taxpayer's own legal costs may arguably be deductible under McKnight v Sheppard and Chu Fung Chee. After all, a concession is just a concession. It confines to what it covers – no more, no less.

16. With regard to Reason 2, Mr A attempted to argue that the other set of court proceedings was highly relevant and turned out to be effective to the extent that a settlement was reached saving much costs which would have otherwise been payable by the Appellant. We made our concern known to Mr A; it was that while he might be right in saying that he was protecting his right to advertise at the disciplinary hearing, the constitutionality of the proceeding which he challenged under the other set of proceedings was entirely a different matter from the right to advertise.

17. Mr A's reply to this was made entirely on the points of fairness and practicality. While we can agree with Mr A that a party to a legal action 'is entitled, so long as legally permissible, to take whatever course which is considered to be most appropriate' in the conduct of the case, we do not think it necessarily be the case that all costs so incurred would have been for the production of chargeable profits and hence deductible for the purposes of profits tax under the Ordinance. This Board concerns the finding of facts and the application of the legal principles to the facts found. That just cannot be a correct application of the relevant legal principles set out above.

18. In an attempt to test further Mr A's submission, we asked Mr A if he was suggesting that whether the hearing was held in public or in camera would have a material bearing on the outcome. While Mr A maintained his positive view towards open conduct of proceedings, he also agreed that one could not be sure if the outcome would be favourable for the respondent solicitor had the disciplinary proceeding been conducted in public. In the absence of further evidence in support of the allegation that the outcome of the disciplinary proceedings would have differed depending on whether they were held in camera or not, Mr A's reply can hardly advance the Appellant's case much.

19. As Ms Cheng put it, which we do not consider Mr A's position much different to the following extent, the Costs arose because Mr A chose to initiate a separate set of court proceedings to challenge the constitutionality of Tribunal hearings in camera. The choice

might be an appropriate one strategically for Mr A's conduct of the disciplinary proceedings against him; however, while the Appellant's own expenses incurred in defending Mr A's case in the Tribunal might be allowable for deduction, it is clear that the principle under Strong v Woodfield as approved in Chu Fung Chee does not extend to cover all other costs even in the same set of proceedings. As such, we cannot see the presence of the required connection between the Appellant's business or profession and the separate set of proceedings no matter how it may be linked with or incidental to the former one; and hence the Costs. This is particularly so since the Costs were costs of the other side of that different set of proceedings, which the Court ordered Mr A as the losing party to pay. This is clearly not what the relevant legal principle means to cover.

20. It suffices to dismiss the appeal on the basis of our analysis above but just in case we were wrong, we do not think any of the other arguments advanced by Mr A would change the outcome of this case.

21. Reason 3 is about the principle in McKnight v Sheppard. First of all, the stockbroker's expenses incurred for the purpose of defending disciplinary proceedings were held an allowable deduction. However, that case did not touch upon any expense incurred for an ancillary proceedings incidental to the main one. In this sense, as explained above, it does not assist the Appellant's case even if the Costs were not costs order of the Tribunal and hence they are not a fine or penalty as such.

22. On the other hand, we agree with Ms Cheng's submission that in McKnight v Sheppard, whether or not an expense was deductible depended on the nature of the expenditure and the specific policy of the rule under which it became payable. So far as the latter part is concerned, the Costs were costs of the other side of that another set of proceedings, which the Court ordered Mr A as the party losing on merit to pay and compensate the other side. Had the Costs been allowed for deduction from the Appellant's chargeable profits, and hence a reduction in the amount of profits tax payable, it would have meant that to be shared by the community. We cannot see any legitimate reason for that being so. We take Ms Cheng's point that 'it is one thing for a taxpayer to incur costs in defending proceedings brought against himself; it is quite another for the taxpayer to be ordered to pay the costs [if we may add, of the other side] of proceedings which he initiated and which he lost'. As such, we would agree with Ms Cheng, if we need make a ruling on this, that the Costs are not deductible under the principle in McKnight v Sheppard even if they are not a fine or penalty.

23. Reason 4 is built on Chu Fung Chee and Mr A sought to distinguish the case by saying that the Costs were incurred not only for the purpose of preserving Mr A's right to practice as a solicitor but were also highly relevant to and closely connected with the Appellant's profit earning. The facts are inevitably different but that does not necessarily warrant a different outcome. The Costs were incurred because Mr A wished to challenge the constitutionality of the Tribunal proceedings being conducted in camera. As explained, that might well be a strategically wise move in relation to his defence in the disciplinary proceedings and hence preserving his right to practice. However, the Appellant has not

shown with any evidential basis how this constitutional challenge might be relevant for the purpose of producing its chargeable profits. At most, it helped enable its precedent partner to continue to practise, which may be considered protecting part of its profit-yielding capital structure. This is why Ms Cheng put forward her third argument that the Costs were capital in nature and so excluded by section 17 of the Ordinance even if they could pass the test under section 16.

Conclusion

24. From the above analysis, we conclude that the Appellant fails on all reasons. This appeal must, therefore, be dismissed.