INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D29/90

Profits tax – failure of taxpayer to appear in person or through a representative – section 68(2B)(b) of the Inland Revenue Ordinance.

Panel: Robert Wei QC (chairman), John D Mackie and Gordon M MacWhinnie.

Date of hearing: 9 May 1990.
Date of decision: 30 August 1990.

The taxpayer was an individual carrying on business in Hong Kong. He disputed an assessment to tax for the year of assessment 1985/86 and appealed to the Board of Review. On the date set for the hearing of the appeal the taxpayer failed to attend in person or by his authorised representative. The preliminary point to be decided by the Board was how to handle the case.

Held:

The Board would proceed to hear the case under section 68(2B)(b) because evidence had been produced that the taxpayer was outside of Hong Kong and was unlikely to be in Hong Kong within a reasonable period. The Board then proceeded to consider the taxpayer's case and dismiss his case on its merits.

Appeal dismissed.

Cases referred to:

Drielsma v Manifold [1894] 3 CA Ch 100 107
Van Den Berghs Ltd v Clark 19 TC 390
Barr Crombie & Co Ltd v CIR 25 TC 406

Luk Nai Man for the Commissioner of Inland Revenue.
Taxpayer in absentia.

Decision:

1. Mr X trading as A Company appeals against the 1985/86 additional profits tax assessment raised on him and confirmed by the Commissioner of Inland Revenue in his

determination dated 14 January 1989. Mr X claims that a sum of $2,350,000 he received from B Ltd is of a capital nature and therefore not chargeable to profits tax.

2. The nature of A Company's business was 'contracts consultants, building and civil engineering, mechanical and electrical engineering'. In August 1980, A Company entered into a service agreement with B Ltd ('the 1980 agreement'). The 1980 agreement was amended twice by agreements dated 21 February 1984 ('the 1984 agreement') and 13 April 1985 ('the 1985 agreement') respectively. The 1980 agreement as amended was terminated on 1 May 1985 in accordance with a letter dated 29 April 1985 from B Ltd to Mr X. The aforementioned sum of $2,350,000 was paid pursuant to paragraph 1(a) of the 1985 agreement.

3. Mr X failed to attend at the meeting of the Board held on 9 May 1990 either in person or by his authorised representative. From his letters to the Commissioner of Inland Revenue dated 14 and 18 April 1990 respectively and copied to the Clerk to the Board of Review, it is clear that Mr X, a resident in Spain, did not come to Hong Kong to attend the hearing because he did not wish to expose himself to the risk of being arrested or having his passport seized by the police as a result of the Inland Revenue Department's action in notifying the police and the Immigration Department that Mr X was a tax defaulter. Under section 77 of the Inland Revenue Ordinance, measures can be taken by the Commissioner of Inland Revenue to prevent a tax defaulter from leaving Hong Kong without paying the tax or furnishing security to the satisfaction of the Commissioner for the payment thereof. Of course, if the tax defaulter succeeds in appealing against his tax assessment, he will be free to leave Hong Kong. The risk is that he may not succeed after all. In the present case, Mr X is unwilling to take that risk. Therefore, it seems unlikely that he will come back to Hong Kong in the foreseeable future. On 29 April 1989 Mr X applied for his appeal to be heard in his absence, albeit for different reasons. On 12 February 1990 he informed the Clerk to the Board that he was making plans to attend the hearing in person, but he did not withdraw his application for a hearing in his absence. On a taxpayer's failure to attend before the Board either in person or by his authorised representative, the Board may take one of three courses depending on the circumstances of the case. They may postpone or adjourn the hearing for such period as they think fit, if satisfied that the failure to attend was due to sickness or other reasonable cause (section 68(2B)(a)). The cause for Mr X's failure to attend was his unwillingness to allow himself to be subjected to the measures the Commissioner may take to prevent him from leaving Hong Kong on the ground of his default in paying tax. We are not satisfied that that is a reasonable cause, so we did not adjourn the hearing. Under section 68(2B)(b), the Board may hear the appeal in the absence of the taxpayer if he is outside Hong Kong and is unlikely to be in Hong Kong within a reasonable period, but this course is open only on the application of the taxpayer made by notice in writing addressed to the Clerk to the Board and received by him at least seven days prior to the hearing of the appeal (see section 68(2D)). We think that the facts of this case bring the appeal within sub-section 2D and we decided to hear the appeal in the absence of Mr X. The third course is to dismiss the appeal under section 68(2B)(c), and that is the course we would have taken if we had not decided to hear the appeal in Mr X's absence.

4. Mr X filed his notice of appeal late but we granted the necessary extension of time to enable the same to be filed in time under section 66(1A). The notice of appeal is accompanied by a statement of grounds of appeal. We perused the correspondence between Mr X and the Inland Revenue Department and treated Mr X's letters as his submissions, Mr Luk for the Revenue having no objection. We also heard Mr Luk's submissions.

5. Mr X's case, as far as we can gather from the statement of grounds of appeal, is that the sum of $2,350,000 was paid to him as compensation for the early termination of the 1980 agreement. Such early termination was a breach of the 1980 agreement and its effect was to materially cripple the whole structure of A Company's profit-making apparatus. A Company's rights under the agreement were a capital asset, and the compensation paid for the loss of those rights was a capital payment.

6. The early termination argument rests on three grounds, two of which are mentioned in the statement of grounds of appeal, while the third is to be found in Mr X's letters to the Commissioner of Inland Revenue.

6.1 The first ground is based on clause 6 of the 1980 agreement and more particularly on the word 'initially' appearing in it. The clause reads:

> ' 6. The agreement will come into effect as from November 1980 and will continue initially for a period of two years or until such time as a fully satisfactory financial settlement is achieved on the [Y project], whichever is the greater period.'

The first limb of the argument is that the word 'initially' refers to both the two years period and the period from November 1980 until a fully satisfactory financial settlement is achieved on the Y project, so that the agreement was to continue initially for the longer of the two periods. We accept that. The second limb of the argument is that the word 'initially' imposes an obligation on B Ltd to enter into a 'follow-on' agreement with A Company on the expiration of the initial period. As it turned out, the initial period expired on 1 May 1985 when a final settlement on the Y project was reached through direct negotiations between B Ltd and C Ltd, which is referred to as 'commercial settlement' in the 1985 agreement. In breach of the 1980 agreement, B Ltd failed to enter into a 'follow-on' agreement with A Company to run from 1 May 1985 and the termination of the 1980 agreement on that day was a wrongful early termination. We are unable to accept that B Ltd was contractually bound to enter into a 'follow-on' agreement with A Company. Such an obligation would have been a contractual term of considerable importance, and one would have expected the 1980 agreement to make express mention of it, instead of leaving it to the reader to infer it (if he can) from the word 'initially'. In our view, that word is insufficient to raise the inference. In the context of the 1980 agreement, we think that the word means that the parties were merely contemplating the possibility of an extension and that the contract was to continue for the initial

period together with any extension that might subsequently be agreed between the parties. In fact no agreement for an extension was made and the 1980 agreement came to an end upon the expiry of the initial period on 1 May 1985. On that day the 1980 agreement as well as the 1984 and 1985 agreements were terminated 'in consequence of the conclusion of all services rendered by [A Company] to [B Ltd] in respect of [Y project] phase 1'. In our view the termination was in accordance with clause 6.

6.2 The second ground may be put in this way. As a result of policy changes made by B Ltd in 1983 resulting in the company ceasing to undertake further major projects, A Company sustained a loss of opportunities to render their services which led to the payment of the sum of $2,350,000 as compensation for early termination on 1 May 1985. In his letter dated 13 April 1987, Mr X put his case this way:

> 'Termination was first intimated to [A Company] towards the end of year 1983, at which juncture [A Company] was verbally informed of a decision which had been taken by the board of directors of [B Ltd]. The decision was to the effect that [B Ltd] no longer intended to undertake any further projects of a major nature, but in future would only carry out smaller type work in which problems involving complex contractual interpretations and large financial requirements would be minimal. In such circumstances the services (general) of [A Company] would no longer required, and henceforth only the specific service of dealing with the outstanding claims on the [Y project] would be necessary.
>
> Termination was again discussed at a meeting held on 13 April 1985, and finally termination was effected on 1 May 1985, in consequence of the conclusion of the main outstanding claims on [Y project] …
>
> In accordance with paragraph 5 of the service agreement, it was the expectation of both parties that [A Company] should devote most of their business efforts to the affairs of [B Ltd]. It was also the expectation (although not expressly stated) that [A Company] would continue to provide a consultancy service on contractual matters for [B Ltd] over the whole of the years that [A Company] intended to remain to do business in Hong Kong. Paragraph 6 of the agreement draws attention to the initial period of service.
>
> For approximately the first two years of the agreement, [A Company] worked on several contracts simultaneously but thereafter the workload tended to concentrate increasingly on the [Y project]. At the date of the first intimation as to termination, [A Company's] workload had gone into another phase of development in regard to [Y project], the reason

being that urgent research and documentation were being required for the purposes of arbitration and/or litigation on that project.

This concentrated and urgent workload continued non-stop until April 1985, a commercial settlement between [B Ltd] and the [Y project] developer (that is, [C Ltd]) suddenly emerged. The workload of [A Company] came to an abrupt end some ten days later, and in consequence [A Company], by way of the terms previously agreed, … were paid a lump sum compensation.

[A Company] have been advised that the lump sum so paid under such circumstances constitutes a capital receipt, on the basis that the rights and advantages surrendered by [A Company] on cancellation of the agreement were such as to materially cripple the whole structure of [A Company's] profit-making apparatus.

In the ensuing eight to nine months period [A Company] made considerable efforts to revive their business affairs with other clients in the industry, but this was not successful.

In consequence [Mr X] (sole proprietor of [A Company]) was forced to early retire in March 1986.'

Mr X also relies on a letter dated 10 May 1988 from B Ltd to the Inland Revenue Department in answer to the latter's queries regarding the payment of the sum of $2,350,000. The letter contains the following particulars:

' (a) The date of payment – 31 July 1985.

(b) The date of agreement of quantum – 13 April 1985.

(c) There was no calculated basis for the lump sum payment.

(d) The purposes for which payment was made:

Compensation for termination of a service agreement (on percentage commission-fee basis) as a result of changes in general company policy.

(e) The payment was made in accordance with letters of agreement dated 13 April 1985 and 29 April 1985.

(f) It is accepted that, technically, this company did "breach" or "change" the original service agreement (dated 6 August 1980), copy of which enclosed, over a period of some five years, as

> general company policies changed, and also ["A Company's"] services had to adapt to these changes accordingly.'

We do not think that Mr X has sufficiently proved the policy changes of B Ltd, as there is no contemporaneous documentary evidence, such as board minutes or resolutions of B Ltd or letters passing between the parties at the time. In its letter quoted above, B Ltd refers to policy changes but does not state the nature of such changes. It states that the payment was compensation for the termination of the service agreement without explaining why it was necessary to pay compensation for the termination. It further states that the payment was made in accordance with he 1985 agreement, but that agreement makes no mention of any compensation, but refers to an agreement to modify 'the commission-fee terms' of the service agreements. The quoted words in our view clearly refer to the remuneration terms. It is Mr X's contention that a lump sum such as the subject sum of $2,350,000 cannot be commission because commission is pro-rata remuneration. We do not agree. Commission may be, but need not be, pro-rata remuneration: see Drielsma v Manifold [1894] 3 CA Ch 100 at 107. Furthermore, as Mr Luk pointed out, clause 1(a) and (b) of the 1985 agreement do not support the compensation argument. If the lump sum in question were compensation for termination of agreement, it would mean that the later the termination date, the more the compensation. Such a result would be inconsistent with the nature of compensation. Paragraph (f) of B Ltd's letter mentions 'breach' without specifying which part of the agreement was 'breached'. In his letter dated 13 April 1987 quoted above, Mr X refers to an expectation, not expressly stated, that A Company would continue to provide a consultancy service for B Ltd over the whole of the years that A Company intended to remain to do business in Hong Kong. He did not put it as high as an implied contractual term that B Ltd was obligated to continue to employ A Company so long as they intended to remain to do business in Hong Kong. In any event no such term can be implied because: (1) on the Moorcock principle it is not required to give business efficacy to the 1980 agreement, nor is it such an obvious thing as not to require express mention, and/or (2) it is contrary to the express provisions of clause 6.

6.3 The third ground is that by negotiating and reaching a commercial settlement direct with C Ltd in April 1985, B Ltd acted in breach of the 1980 agreement which did not provide for settlement by commercial means, and that the termination on 1 May 1985 as a result of the commercial settlement was an early termination. In other words, the contention is that by appointing A Company to negotiate claims, B Ltd precluded itself from negotiating direct with C Ltd for a settlement and must always leave the negotiation in the hands of A Company. We do not agree. In our view, clause 6 of the 1980 agreement applies to a final settlement on the Y project, whether through negotiations conducted by A Company or B Ltd, and, by the 1985 agreement, the parties

agreed on lump sum remuneration terms in the event of a commercial settlement.

7. Mr X relies on two decided cases, Van Den Berghs Ltd v Clark 19 TC 390 and Barr Crombie & Co Ltd v CIR 25 TC 406 for showing that in cases of this type, a relevant consideration is whether the termination of the agreement in question materially affected the whole structure of the profit-making apparatus. The facts in the Barr Crombie case are closer to the present case. In each of the decided cases the lump sum was paid for early termination of an agreement which had thirteen more years to run in the first case and eight years to run in the second, and was paid as compensation for the surrender or loss of rights and benefits under the cancelled agreement. In our view they have no application to the present case where the termination was in accordance with contractual provisions and the lump sum was paid as remuneration for services rendered up to the date of termination. That being so, it is unnecessary to deal with the question whether the service agreements related to the whole structure of A Company's profit-making apparatus.

8. For these reasons the appeal is dismissed and the assessment in question is hereby confirmed.