INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D53/90

Profits tax – professional firm – termination of professional business and commencement of new partnership business – whether payment by new partnership to proprietor of original business is taxable income.

Profits tax – whether different ground of appeal can be introduced.

Panel: T J Gregory (chairman), Kenneth Kwok Hing Wai and Larry Kwok Lam Kwong.

Dates of hearing: 2 and 3 May 1990.
Date of decision: 3 January 1991.

The taxpayer was carrying on a professional business. He commenced a new partnership business which acquired the original business previously carried on by him. He argued that certain payments received by him from the new partnership were not taxable income of his original business. He further argued that as his original business had terminated any payments received by him could not be assessable.

Held:

The grounds of appeal did not include the claim that the taxpayer had terminated his business and therefore he could not pursue this ground of appeal. With regard to whether the payment was taxable the Board agreed with the Commissioner.

Appeal dismissed.

Cases referred to:

The Commissioners of Inland Revenue v The South Behar Railway Co Ltd 12 TC 657
Tryka Ltd v Newall [1963] TR 297

H Bale for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. THE NATURE OF THE APPEAL

The Taxpayer, the sole proprietor of a professional practice bearing his name, objected to an additional profits tax assessment for the year of assessment 1984/85 and the profits tax assessment for the year of assessment 1985/86 which had been raised on him.

2. THE FACTS

2.1 The Taxpayer had carried on a professional practice in Hong Kong from 1976. In December 1982 the Taxpayer entered into an agreement ('the agreement') with four individuals, who gave the same address in London, and a Hong Kong company.

2.2 The agreement recited that the professional practice was carried on by the Taxpayer as a sole proprietor and that with effect from 1 January 1983 the parties would carry on that profession in partnership upon the terms contained in a deed of partnership in December 1982 ('the new partnership').

2.3 With the exception of certain specific items the professional practice and the assets of that practice previously carried on by the Taxpayer were acquired by the new partnership.

2.4 The agreement also contained provisions for apportionment of fees in respect of work in progress and for the splitting of certain other future fee income and refer paragraph 6.4 below.

2.5 In his profits tax return for the year of assessment 1983/84 the Taxpayer declared, and included as income, an item described as 'apportionment fees' from the new partnership in the sum of $405,421.90. On 4 September 1984 the assessor raised a profits tax assessment in accordance with the return but by letter dated 4 October 1984, received by the Revenue on 12 October 1984, the Taxpayer informed the Revenue that:

> ' By our previous return, an amount of $405,421 was incorrectly shown as an item of income in the profit and loss account whereas such sum should in fact only be shown in the balance sheet as payment received from [new partnership named] as reflecting parcel payment for goodwill transferred to the amalgamated practice…'

2.6 The letter was rejected as a valid notice of objection because it was not received within one month after the date of the notice of assessment.

2.7 In his profits tax return for 1984/85, based on accounts for the year ended 31 July 1984, the Taxpayer declared a loss of $10,232. In the balance sheet as at 31 July 1984 the sum of $783,063, described as 'goodwill received from [new partnership named]', was credited to the capital account. This sum was not included as income in the profit and loss account.

2.8 In response to enquires raised by the assessor regarding the declining turnover of the firm, the Taxpayer gave the following explanation:

> ' According to the sale and purchase agreement made in December 1982 that with effect from 1 January 1983, [Taxpayer's firm named] transferred the whole of the undertaking and assets of the practice to [new partnership named], thus resulting in the tremendous drop in the income for the year ended 31 July 1984.'

2.9 On 2 August 1985 a profits tax assessment was raised on the Taxpayer based on the return.

2.10 On 14 October 1985 the Taxpayer applied under section 70A of the Inland Revenue Ordinance for the revision of the 1983/84 assessment on the ground that '… the assessments are excessive because the parcel payment in the sum of $405,421 for goodwill transferred to the amalgamated practice, had erroneously been included in the profits tax return for the above year of assessment as assessable income. As the same sum is not trading receipt, it is therefore outside the scope of charge to profits tax'.

2.11 Upon request a copy of the agreement was submitted by the Taxpayer.

2.12 By letter dated 13 January 1986 a firm of certified public accountants, on behalf of the new partnership, supplied the following information in connection with the agreement:

> ' <u>Apportion to [Taxpayer named]</u>
>
> … All billings subsequent to the formation of the partnership (1 January 1983) were individually reviewed by the partners to assess the element of work performed prior to the formation of the partnership and consequently due to [Taxpayer named] in his own name.
>
> <u>Goodwill</u>
>
> The partnership did not make any specific payments in its own name for goodwill. No value was specifically assigned to goodwill in the sale and purchase agreement and no accounting entries were made. However, the sale and purchase agreement (paragraph 1(d)) does

> specify the transfer of the goodwill and undertaking of the [Taxpayer's firm named] practice which shall include … the full benefit of all pending engagements and instructions relating to the [Taxpayer's firm named] practice.
>
> In the accounts of [new partnership named] for the years ended 31 December 1983 and 31 December 1984 no attempt was made to separate a goodwill element as the apportionments made related directly to income "earned" by the new partnership [new partnership named].'

2.13 After reviewing the agreement, the assessor was of the view that the receipts in respect of apportioned fees were in respect of work performed by the Taxpayer prior to the formation of the new partnership and were due to the Taxpayer's professional practice. A notice of refusal to correct the assessment was issued on 25 February 1986. The Taxpayer did not appeal further.

2.14 On 3 May 1986 the Taxpayer submitted the profits tax return for the year of assessment 1985/86 in respect of his firm and declared assessable profits at nil. No business accounts were attached.

2.15 On 19 June 1987 the assessor raised on the Taxpayer the following additional assessment for 1984/85 and an assessment for 1985/86:

1984/85 (Additional)	$
Assessable profits as notified before	28,314
Add: 'Goodwill' received from the new partnership	783,063
Adjusted assessable profits	$811,377
Less: Already assessed	28,314
Additional assessable profits	$783,063

1985/86	
Estimated assessment under section 59(2)(b)	$400,000

2.16 The Taxpayer, through his new tax representative, lodged an objection against the additional assessment for 1984/85 on the following grounds:

‘ 1. The amount is excessive;

2. The amount of receipt in the form of “goodwill” is of a capital nature and definitely not an income arising from the ordinary course of our client’s business and is therefore outside the scope of the charge to profits tax under the Inland Revenue Ordinance.’

2.17 The tax representative also objected against the assessment for 1985/86 in the following terms:

‘ 1. The amount is excessive;

2. The amount is not based on our client’s actual trading profits for the year concerned.’

2.18 On 17 September 1987, in response to the assessor’s request, the representative submitted the business accounts of the Taxpayer’s firm for 1985/86 (year ended 31 July 1985). The sum of $206,248 described as ‘goodwill received from [new partnership named]’ was credited to the balance sheet as at 31 July 1985. The sum was not included as income in the profit and loss account.

2.19 The assessor was of the view that the items in dispute for 1984/85 and 1985/86 in the amount of $783,063 and $206,248, respectively, were of an income nature and were correctly assessable to profits tax. By letter dated 16 August 1988 the assessor proposed to settle the objection as follows:

‘ <u>Year of Assessment 1984/85 (Additional)</u>

Additional assessable profits to be confirmed as $783,063.

<u>Year of Assessment 1985/86</u>

Assessable profits to be revised to $206,248.’

2.20 The Taxpayer did not agree to the proposal and the representative provided further information and argument.

2.21 By his determination dated 8 February 1990 the Deputy Commissioner of Inland Revenue:

2.21.1 confirmed the additional profits tax assessment for the year of assessment 1984/85; and

2.21.2 revised the assessable profits of $400,000 for the year of assessment 1985/86 to $204,698.

2.22 By letter dated 28 February 1990 the Taxpayer gave notice of appeal and set out his grounds of appeal as follows:

> ' a) The Commissioner's reasons for the determination were insufficient for the determination that the particular sums received by [the Taxpayer] were of an income nature.
>
> b) The Commissioner failed to recognize that payment for goodwill (or indeed payment under any agreement) may take a multitude of forms or arrangement. And what may constitute goodwill which may be passed on to the newcomer of a business is strictly a matter decided by the parties.
>
> c) The Commissioner failed to take proper cognizance of the fact that [the Taxpayer's firm] became a dormant company immediately upon the constitution of a new partnership (on 1 January 1983) and should not be regarded as still capable of carrying on a trade, profession or business and deriving income therefrom. The tax position of [the Taxpayer] should have been no worse off than if [the Taxpayer's firm] had been dissolved.'

2.23 By letter dated 27 April 1990, the Taxpayer notified the Clerk to the Board of Review that '… I will withhold from making any submission in respect of grounds (a) and (b) of my appeal and concentrate on ground (c). My submission will be brief. No new factor will be submitted and no witness need to be called.'

2.24 The Taxpayer lodged profits tax returns with profit and loss accounts and balance sheets as follows:

Year of Assessment	Accounting Period	Date Return Issued	Date Return Signed
1983/84	1-8-82 to 31-7-83	2-4-84	26-5-84
1984/85	1-8-83 to 31-7-84	1-4-85	16-4-85
1987/88	1-8-86 to 31-7-87	6-4-88	3-5-88

3. CASE FOR THE TAXPAYER

3.1 The Taxpayer appeared in person and having been affirmed in English handed to the Board a written submission which included the following:

> ' Although I have objected to such assessments on the ground of their not being of an income nature, on reviewing the determination together

with reasons therefor by the Commissioner, I conclude that in the circumstances such a ground is untenable and I now accept the sums concerned were of income nature. However my last ground of objection being ground (c) given in my notice of appeal is still valid and becomes the only ground of objection that I rely upon in this hearing.

In point of law, I have since 1 January 1983 been bounded by the agreement with the new partnership to cease to practise in Hong Kong, China and Taiwan otherwise than as a partner in the new partnership and in point of fact, I did cease from 1 January 1983 to practise except as a partner of the new partnership. Therefore on the premise the sums concerned were regarded as of income nature, they should have been assessed as additional incomes to the old partnership prior to its being put into a dormant state rather than as income in the subsequent years for which it has already ceased to practise. The additional assessment of $783,063 for the assessment year 1984/85 and the assessment of $206,248 for the assessment year of 1985/86 were both wrong in law, in my humble opinion, and I will beg the Board to uphold my objection to these assessments.'

3.2 After examining the submission the Board asked the Taxpayer whether or not he agreed that, de facto, his submission constituted an application to amend whereby the ground of appeal would be 'in the alternative the receipts of $783.063 and $206,248 were income attributable to the year of assessment 1982/83 and not the years of assessment 1984/85 and 1985/86, respectively, and, accordingly, are not taxable as assessed'.

3.3 In light of section 66(3) of the Ordinance the Board felt it appropriate to allow the Revenue an overnight adjournment to consider whether the Revenue would oppose an application for amendment.

3.4 On resumption, having heard from both the Taxpayer and the representative of the Revenue, the Board gave the following ruling:

' Ground (c) of the grounds of appeal is the only ground being pursued by the Taxpayer. This ground can only reasonably be read to mean that the Taxpayer disputed the treatment by the Commissioner of the two amounts in question as income, as opposed to capital.

In his evidence to the Board the Taxpayer for the first time acknowledged these receipts as income and submitted they should be treated as income of his sole proprietorship in the last year of its active business, that is to 31 December 1982 since when that business has been dormant, but not dissolved.

The Board considered this evidence as a new ground of appeal and in an attempt to assist the Taxpayer suggested wording for this ground as:

> "In the alternative the receipts of $783,063 and $206,248 were income attributable to the year of assessment 1982/83 and not the years of assessment 1984/85 and 1985/86, respectively, and, accordingly, are not taxable as assessed."

The Board invited the Revenue to address on whether the Board should exercise its discretion under section 66(3) to permit this last minute amendment.

The Revenue objected on the grounds that although this matter has been under correspondence since June of 1987, at the latest, the first acknowledgement by the Taxpayer that the receipts were income was made during this hearing. Further the Revenue could not re-open a 1982/83 assessment because section 70 prevents this. This is not disputed by the Taxpayer.

The Board is of the view that it would be inappropriate to allow an amendment at this late stage which would enable the Taxpayer, by adopting an alternative approach, to call in aid the time bar imposed by section 70.

Accordingly, the Board declines to exercise its discretion to allow the amendment.'

3.5 The Taxpayer was then cross-examined on his written submission.

3.6 The Board does not consider it necessary or appropriate to record the evidence of the Taxpayer in chief or under cross-examination in this decision.

4. CASE FOR THE REVENUE

4.1 The submission on behalf of the Revenue was to the effect that the receipts in question were income of the Taxpayer.

4.2 The Board's attention was drawn to the provisions of the agreement dealing with apportionment of the receipts of the new partnership.

4.3 It was pointed out that the Taxpayer's accounts had always been prepared on a cash basis and were assessed as such. No work-in-progress was shown in the Taxpayer's accounts as at 31 July 1982, and this had been confirmed by his representative in correspondence with the Revenue. The assessments for the years 1982/83, 1983/84 and 1984/85 were made on accounts prepared on the

same basis. Accordingly, the Taxpayer was allowed all expenses in full. Fees received by the new partnership which were apportioned by reference to the provisions of the agreement and paid or credited to the Taxpayer had been excluded from the income of the new partnership. As these payments to the Taxpayer were of a revenue nature they are properly chargeable to profits tax.

4.4 The Board was then taken through the Taxpayer's profits tax returns and referred to the explanation from the auditors of the new partnership, refer paragraph 2.12 above.

4.5 The Taxpayer had alleged that his business had become 'dormant' with effect from 1 January 1983 when the new partnership came into existence, whereby subsequent receipts were not receipts from the carrying on of a trade or business. This was not the case; the business continued entitled to fees for work undertaken prior to and subsequent to that date. Further, the fact that the business was not dormant was evidenced by the filing of profits tax returns for a later period.

4.6 The Board was then referred to The Commissioners of Inland Revenue v The South Behar Railway Co Ltd 12 TC 657 and the approach of the House of Lords to income received during a period of apparent dormancy.

5. REPLY BY THE TAXPAYER

5.1 In his reply the Taxpayer conceded that the receipts were income but asserted that as the business was no longer carrying on business the receipts were his and not those of the business.

5.2 The Board was referred to:

5.2.1 a passage in a paragraph 5-27 in Wheatcroft's Income Tax (edition not provided) as authority for the proposition that the mere realisation of assets does not, of itself constitute trading; and

5.2.2 a passage from a judgment in Tryka Ltd v Newall (report and subject matter not identified) dealing with the distinction between the law relating to bankruptcy as it applies to the carrying on of a business by a debtor purely to collect debts due and income tax law.

6. REASONS FOR THE DECISION

6.1 It is common ground that the receipts which have been assessed to tax were paid by the new partnership to the Taxpayer pursuant to the agreement.

6.2 The grounds of appeal submitted that the receipts were of a capital nature and, accordingly, were not assessable to tax. However, the Taxpayer has accepted that the receipts were not capital payments whereby this point does not fall for consideration by the Board. However, because of clause 6 of the agreement, which is quoted in paragraph 6.4 below, the Board feels obliged to comment that the Taxpayer was correct in not pursuing this argument.

6.3 As the appeal developed the submissions of the Taxpayer were:

6.3.1 That the Taxpayer's business was dormant from 31 December 1982, whereby the receipts in question could not be receipts arising from the carrying on of a trade or business and, accordingly, are not taxable; and

6.3.2 That the Taxpayer's business was dormant from 31 December 1982, whereby the receipts in question could not be paid to or belonged to the business but belonged to the Taxpayer himself and whereby the assessments were wrong. As this latter submission is not based on a ground of appeal the Board is not empowered to afford it any consideration.

6.4 In common with the Deputy Commissioner, the Board is satisfied that the nature of the receipts can be ascertained from the terms of the agreement. The relevant provisions of the agreement are contained in clause 6 which reads as follows:

> ' All work in progress and contracts in connection with the practice subsisting as at the transfer date shall be dealt with as follows:
>
> "(a) All contracts which are assignable by [the Taxpayer] without the consent of any other party and all contracts for the assignment of which consent shall have been given shall be assigned to the partnership or (as the case may be) to the company as and when the other parties hereto so require.
>
> (b) All contracts not so assignable and work in progress in connection therewith shall as from the transfer date be carried out by the partnership as sub-contractor for [the Taxpayer] on the basis that [the Taxpayer] shall continue his obligations to the other party or parties under such contracts but that all profits and losses arising thereout shall belong to or be borne by the partnership and [the Taxpayer] in accordance with the provisions of this clause.
>
> (c) [The Taxpayer] will as and when requested by the partnership endeavour to obtain all necessary consents for

the assignment of any contracts for the assignment of which any consent shall be necessary.

(d) Fees received in respect of work in progress of the practice whether received before or after the transfer date and whether by [the Taxpayer] or the partnership shall be accounted for between the parties as follows:

(i) Fees in respect of property management shall be apportioned on a time basis so that the proportion referable to periods prior to and including the transfer date shall belong to [the Taxpayer] and the proportion referable to periods after the transfer date shall belong to the partnership;

(ii) [The Taxpayer] shall be entitled to 25% and the partnership to 75% of fees receivable in respect of agency matters on which instructions were received by the practice prior to or on the transfer date;

(iii) Fees receivable in respect of [the professional work] on which instructions were received by the practice prior to or on the transfer date shall be apportioned between [the Taxpayer] and the partnership reference to the proportion of the total amount of work involved which was carried out prior to the transfer date to the intent that [the Taxpayer] shall receive 25% or 50% or 75% (as may be most appropriate) of such fees and the partnership shall receive the balance."'

6.5 This clause imposed obligations on the Taxpayer which extended beyond 31 December 1982 and which may be summarised as follows:

6.5.1 Pursuant to sub-clause (a):

To keep his business in operation until such time as the parties to the agreement required both the assignment of the contracts which were assignable to be assigned and consent was obtained to the assignment of the contracts for which consent was required.

6.5.2 Pursuant to sub-clause (b):

To keep his business in operation to perform the contracts which were not assignable, albeit that the business would sub-contract the performance thereof to the new partnership.

6.6 This clause also required the business to continue in operation beyond 31 December 1982 for the following reasons:

6.6.1 Pursuant to sub-clause (d)(i):

To receive fees earned to 31 December 1982 but paid at a later date to be paid to it.

6.6.2 Pursuant to sub-clause (d)(ii):

To receive the percentage of the fees referred to therein.

6.6.3 Pursuant to sub-clause (d)(iii):

To receive the percentage final fee earned to 31 December 1982.

6.7 The Board notes that the accounts of the Taxpayer were prepared on a cash basis. In other words, the Taxpayer off-set all expenses incurred in an accounting period notwithstanding that these expenses referred to work-in-progress which may have been billed in that period or which remained to be billed in the next accounting period, the receipt in payment for that work being accounted for in the accounting period in which the debit note was paid as opposed to render. The Taxpayer's statement that a payment received when the recipient was dormant could not be a receipt from the carrying on of a trade profession or business is untenable. It is tantamount to stating that the taxation of profits can be totally avoided by preparing accounts on a cash basis and ceasing the business before rendered fee notes were paid. This is supported by The Commissioners of Inland Revenue v The South Behar Railway Co Ltd.

6.8 The Board also notes that the Taxpayer did not give notice to the Revenue, that his practice had ceased business, indeed he could not, and the fact that the Taxpayer did not regard the firm as dormant is evidenced by the fact that accounts were prepared and lodged together with profits tax returns for periods subsequent to the date of commencement of business of the new partnership. The Board also notes the reply given to a Revenue enquiry and quoted in paragraph 2.8 above.

6.9 The submission that the Taxpayer was dormant was clearly conceived for the purposes of affording some semblance of justification of this appeal. The Board is satisfied that the Taxpayer was not a dormant entity at the time of the receipt in question and that the assessments were correctly made.

7. DECISION

For the reasons given this appeal fails.