

INLAND REVENUE BOARD OF REVIEW DECISIONS

**Case No. D65/02**

**Profits tax** – partnership – loss carried forward by a partner – whether set off available – section 19C of the Inland Revenue Ordinance ('IRO').

Panel: Kenneth Kwok Hing Wai SC (chairman), Colin Cohen and Kenneth Ku Shu Kay.

Date of hearing: 13 September 2002.

Date of decision: 30 September 2002.

The appellant is a partnership formed in December 1995. One of the partners, the HK partner (a corporation), had tax loss carried forward from the year of assessment 1995/96. The tax loss was sustained prior to the formation of the partnership. The appellant contended that the HK partner was entitled to set off the tax loss against the profits of the appellant in subsequent years of assessment under section 19C(4) of the IRO.

**Held:**

The Board ruled that the appellant's contention was correct. Under section 19C(4) of the IRO, a corporation is entitled to set off its loss in one year against its share profits from a new partnership in subsequent years of assessment.

**Appeal allowed.**

Lee Yun Hung for the Commissioner of Inland Revenue.

Patrice Marceau of Messrs Baker & McKenzie for the taxpayer.

**Decision:**

1. This is an appeal against the determination of the Commissioner of Inland Revenue dated 4 June 2002 whereby:

- (a) Additional profits tax assessment for the year of assessment 1996/97 under charge number 2-1151407-97-2, dated 16 January 2001, showing additional

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assessable profits of \$1,445,153 with additional tax payable thereon of \$238,450 was confirmed.

- (b) Profits tax assessment for the year of assessment 1997/98 under charge number 2-1068541-98-5, dated 19 November 1998, showing assessable profits of \$9,223,380 with tax payable thereon of \$1,521,857 was reduced to net assessable profits of \$7,241,470 (after set off of loss of \$1,981,910 sustained by the HK partner) with tax payable thereon of \$1,075,358.
- (c) Profits tax assessment for the year of assessment 1998/99 under charge number 2-1054776-99-3, dated 11 November 1999, showing assessable profits of \$4,855,784 with tax payable thereon of \$776,925 was confirmed.

2. The facts in ‘Facts upon which the determination was arrived at’ in the determination was admitted by the Appellant and we find them as facts.

3. The Appellant is a partnership formed under a partnership agreement dated 4 December 1995 and commenced business on 1 January 1996. One of the partners, the HK partner, is a corporation and had a tax loss of \$14,070,970 carried forward from the year of assessment 1995/96. This tax loss of \$14,070,970 had been sustained by the HK partner prior to the formation of the partnership. The Appellant contended that the HK partner was entitled to set off this tax loss against its share of the assessable profits of the Appellant for the years of assessment 1996/97, 1997/98 and 1998/99 under section 19C(4) of the IRO. The Respondent contended that it could not because the loss had been sustained before the partnership was formed.

4. Section 19C provides as follows:

*‘(1) Subject to section 19CB, where in any year of assessment –*

- (a) an individual sustains a loss in any trade, profession or business carried on by him; and*
- (b) the individual or, in the case of a husband and wife, not being a wife living apart from her husband, the husband or wife does not elect for personal assessment under section 41 for that year of assessment, (Amended 43 of 1989 s. 9)*

*the amount of that loss shall be carried forward and set off against the amount of his assessable profits from that trade, profession or business for subsequent years of assessment. (Amended 71 of 1983 s. 17)*

*(2) Subject to section 19CB, where in any year of assessment –*

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- (a) *an individual incurs a share of a loss of a partnership in any trade, profession or business carried on by that partnership; and*
- (b) *the individual or, in the case of a husband and wife, not being a wife living apart from her husband, the husband or wife does not elect for personal assessment under section 41 for that year of assessment, (Amended 43 of 1989 s. 9)*

*the amount of that share of the loss shall be carried forward and set off against the amount of his share of assessable profits of the partnership from that trade, profession or business for subsequent years of assessment: (Amended 71 of 1983 s. 17)*

*Provided that where at the end of the year of assessment commencing on 1 April 1983 a share of a loss to be carried forward under this subsection is one that was incurred by a husband and wife, not being a wife living apart from her husband, in partnership with each other, whether or not also with other persons –*

- (i) *the share of the loss shall be deemed to be apportioned between the husband and wife in the proportions in which they were entitled to share profits between themselves as at the last day of the basis period for that year of assessment; and*
  - (ii) *each such portion of the share of the loss shall be carried forward and set off against the husband's or, as the case may be, the wife's respective share of assessable profits of the partnership from that trade, profession or business for subsequent years of assessment. (Added 71 of 1983 s. 17)*
- (3) *Subject to subsection (3A), where in any year of assessment an individual has sustained a loss or has incurred a share of a loss of a partnership and –*
- (a) *is personally assessed under Part VII; or*
  - (b) *in the case of a husband and wife, not being a wife living apart from her husband, the husband or wife is personally assessed under Part VII, (Replaced 43 of 1989 s. 9)*

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*the amount of the loss or share of the loss shall be dealt with in accordance with that Part. (Replaced 71 of 1983 s. 17)*

- (3A) *For the purposes of Part VII, where the loss or the share of the loss referred to in subsection (3) consists solely of the balance of an unabsorbed loss calculated in accordance with section 19CA(2)(b), the amount of the loss or the share of the loss shall be deemed to be the amount arrived at by dividing such balance by the adjustment factor within the meaning of section 19CA. (Added 32 of 1998 s. 12)*
- (4) *Subject to section 19CB, where in any year of assessment a corporation or a person, who is not an individual, a partnership or a corporation, carrying on a trade, profession or business sustains a loss in that trade, profession or business, the amount of that loss shall be set off against the assessable profits of the corporation or person (including its share of the assessable profits of a partnership in which it is a partner) for that year of assessment and to the extent not so set off, shall be carried forward and set off against the corporation's or the person's assessable profits and its share of assessable profits of such a partnership for subsequent years of assessment.*
- (5) *Subject to section 19CB, where –*
- (a) *a trade, profession or business is carried on in Hong Kong by persons in partnership and any one of those persons is a corporation or is a person who is not an individual, a partnership or a corporation; and (Amended 7 of 1986 s. 12)*
  - (b) *in any year of assessment a loss is incurred in that trade, profession or business,*

*then the corporation's or the person's share of that loss shall be set off against the assessable profits of the corporation or the person for the year of assessment in which the loss was incurred and to the extent not so set off, be carried forward and, for subsequent years of assessment, be set off first against the corporation's or the person's share of the assessable profits of such partnership and, to the extent not so set off, then against the assessable profits of the corporation or the person.*

- (6) *For the purposes of this section –*

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- (a) *the amount of any loss set off in computing the assessable profits for any year of assessment shall not be set off in computing the assessable profits for any other year of assessment;*
  - (b) *the amount of any loss carried forward to any year of assessment to be set off against the assessable profits for that year shall not be set off more than once in that year of assessment;*
  - (c) *the total amount set off against assessable profits shall not exceed the amount of the loss;*
  - (d) *the amount of any loss to be set off under this section shall be the loss attributable to activities in Hong Kong; (Amended 30 of 1981 s. 4; 7 of 1986 s. 12)*
  - (e) *the amount of any loss sustained in any trade, profession or business carried on for the benefit of a trust by a person in his capacity as trustee shall not be available for set off except against the assessable profits of that trust from that trade, profession or business for subsequent years of assessment. (Added 30 of 1981 s. 4)*
- (7) *For the purposes of this section –*
- (a) *“partnership” (合夥) does not include a partnership (other than a partnership referred to in section 345(2) of the Companies Ordinance (Cap 32)) consisting at any time in the year of assessment of more than 20 partners;*
  - (b) *in calculating the number of partners in a partnership, there shall be included every partner in any other partnership which is itself a partner in the first-mentioned partnership. (Replaced 51 of 1978 s. 9)*
- (8) *This section shall apply to the year of assessment commencing on 1 April 1975 and to subsequent years of assessment.’*

5. What is at issue is the meaning of ‘such a partnership’ in subsection (4).

6. Under subsection (4), the loss from one trade, profession or business is available for set off against:

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- (a) the assessable profits of the corporation from some other trade, profession or business; and
- (b) its share of the assessable profits of a partnership in which it is a partner.

Mr Lee Yun-hung conceded that the set off is available against the assessable profits of the corporation from a new trade, profession or business in subsequent years of assessment. As (b) is **included** in (a) we see no reason why the set off should be restricted to partnerships in existence at the time when the loss was sustained.

7. Under subsection (5), a corporation's share of the loss incurred in a trade, profession or business carried on by the corporation in partnership with another or others is available for set off against the assessable profits of the corporation. Mr Lee Yun-hung conceded that the set off is available against the assessable profits of the corporation from a new trade, profession or business in subsequent years of assessment. We see no reason why a corporation's loss in one year is not available for set off under subsection (4) against the profits from a new partnership in subsequent years of assessment.

8. According to the explanatory memorandum to the amendment bill adding section 19C:

‘ [Clause 16] also provides that losses of a corporation which in addition to trading on its own account also trades as a partner in a partnership shall have losses set off in either activity against profits made in either.’

9. What ‘ a partnership in which it is a partner’ requires is that the corporation must be a partner of the partnership before its share of the assessable profits of the partnership may be set off against the loss sustained by the corporation in a trade. Thus the explanatory memorandum referred to trading as a partner in a partnership. This excludes cases where a corporation is not a partner of the partnership but shares the partnership profits in some other capacity. Examples include a landlord's share of the profits of a tenant (a partnership) under a tenancy agreement, and a consultant's share of the profits of a client (a partnership) under a consultancy agreement. What is important is that the corporation must be a partner at the time of the share of profit, not whether the corporation was a partner at the time the corporation sustained a loss in a trade.

10. In our decision, ‘ such a partnership’ means ‘ a partnership in which it is a partner’ . Thus, subsection (4), so far as material, reads as follows:

*‘ ... where in any year of assessment a corporation ... carrying on a trade, profession or business sustains a loss in that trade, profession or business, the amount of that loss shall be set off against the assessable profits of the corporation ... (including its share of the assessable profits of a partnership in*

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*which it is a partner) for that year of assessment and to the extent not so set off, shall be carried forward and set off against the corporation's ... assessable profits and its share of assessable profits of a partnership in which it is a partner for subsequent years of assessment'.*

11. In our case, the HK partner sustained a loss by the year of assessment 1995/96. \$14,070,970 was the extent not so set off by the year of assessment 1995/96. \$14,070,970 should be carried forward and set off against the HK partner's share of assessable profits of the Appellant in which the Appellant was a partner for subsequent years of assessment 1996/97, 1997/98 and 1998/99.

12. We invited Mr Lee Yun-hung to formulate what the Respondent contended should be read in place of 'such a partnership' and he suggested the following formulation:

' a partnership which was already in existence when the loss was incurred by the corporation' .

13. As Mr Patrice Marceau observed, this formulation is defective in that it omitted any mention of the requirement that the corporation must be a partner of the partnership. If ' of which it was and is a partner' is added to Mr Lee Yun-hung's formulation, the revised formulation is tantamount to rewriting the statute instead of construing it.

14. If the legislature had intended what the Respondent contended, it could have done so by simply using the word 'that'. Thus instead of 'its share of assessable profits of **such a** partnership for subsequent years of assessment', it could have said 'its share of assessable profits of **that** partnership for subsequent years of assessment' .

15. Contrast what the legislature did for subsections (1) and (2). In subsection (1), the use of the word 'that' in 'profits from that trade, profession or business for subsequent years of assessment' restricts the set off to the same trade. In subsection (2), the use of the word 'that' in 'profits of the partnership from that trade, profession or business for subsequent years of assessment' restricts the set off to the same trade carried on by the same partnership. In contrast, the legislature chose not to use the word 'that' in subsection (4) to indicate that the restriction contended by the Respondent was not intended.

16. For reasons given above, the Appellant has discharged its onus of satisfying us that the assessments appealed against are incorrect and excessive. We allow the appeal and:

- (a) **annul** additional profits tax assessment for the year of assessment 1996/97 under charge number 2-1151407-97-2, dated 16 January 2001, showing additional assessable profits of \$1,445,153 with additional tax payable thereon of \$238,450;

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- (b) **reduce** profits tax assessment for the year of assessment 1997/98 under charge number 2-1068541-98-5, dated 19 November 1998, showing assessable profits of \$9,223,380 with tax payable thereon of \$1,521,857 to net assessable profits of \$4,611,690 (after set off of loss of \$4,611,690 sustained by the HK partner) with tax payable thereon of \$684,836; and
- (c) **reduce** profits tax assessment for the year of assessment 1998/99 under charge number 2-1054776-99-3, dated 11 November 1999, showing assessable profits of \$4,855,784 with tax payable thereon of \$776,925 to net assessable profits of \$2,427,892 (after set off of loss of \$2,427,892 sustained by the HK partner) with tax payable thereon of \$388,462.