HONG KONG

A Review of Recent Board of Review Cases

■ ***Jody Wong***
Teaching Fellow

Percy Wong
Teaching Fellow
School of Accounting and Finance
The Hong Kong Polytechnic University

This article will review the cases reported in the second and third supplements of Volume 33 of Board of Review Cases, which were published in April and July 2019, respectively. There are four profits tax cases, five salaries tax cases, one property tax case, one appeal out of time case, and one case on penalty and costs of a hearing. Regarding the four profits tax cases, two are on property disposal, one is on a source issue, and one looks at whether the lending of money constitutes business. The salaries tax cases cover the issues of deduction of professional subscription fees, deduction of home loan interest, source of employment, chargeability of termination payment, and finalization of tax liability.

Property Tax and Salaries Tax (Home Loan Interest)

D14/17 and D15/17

These two cases concerned the same taxpayer. The taxpayer leased a property at Address B (the Residence) at a monthly rent of $30,000 for two years from 10 June 2013. On 3 September 2013, she acquired a property at Address C (the Property) as a sole owner and obtained a bank loan which was secured by a legal charge over the Property. Both the Residence and the Property were in the same building. In order to honour the lease agreement, to avoid spending any additional renovation costs, and to minimize her dwelling expenses, the Taxpayer decided to stay at the Residence and let out the Property at the same monthly rental of $30,000 from 8 September 2014 to 7 September 2016.

In **D14/17**, property tax assessments were raised on the Taxpayer for the years of assessment 2014/15 and 2015/16. The Taxpayer objected to the assessments on the grounds that no income was generated from the Property, which was her “dwelling/basic shelter”, and that her rental income from the Property was wholly set off by her rental payments for the Residence.

The Board held that as the owner of the Property, the Taxpayer was chargeable to property tax, which was computed on the net assessable value of the Property under section 5(1). Whilst it was correct to say that no one was forced to dwell in a property they owned, it was equally true that if one generated rental income from a property, one would be subject to paying property tax. It did not matter whether a property was the only property a person owned or whether the person rented another property to dwell in for which rent was payable. Section 5(1A) did not allow any deduction of rent payable for another property even if two properties were located in the same building.

The Board dismissed the appeal and ordered the Taxpayer to pay $6,000 as costs.

As another issue, in **D15/17**, the Taxpayer claimed that the Property was her only basic shelter and that she, like any other first-time property owner, should be allowed deduction of home loan interest under salaries tax for the year of assessment 2014/15. She alleged that she did stay in the Property before letting it out in that year.

The Board considered that section 26E(1) envisaged that a property could be used by a person either exclusively or partly as his place of residence. That explained the purpose of section 26E(2)(a), which allows an adjustment of the amount of home loan interest to be deducted where a person dwells in a property partly as his place of residence but at the same time dwells partly in another property. However, the Taxpayer was unable to prove that the Property had ever been used by her as a place of residence, principally or otherwise, during the period from 1 April 2014 to 7 September 2014. The electric consumptions of the Property were 13 to 17 times less than those of the Residence, with water consumption almost negligible at the Property. It was difficult to accept that she had used both the Residence and the Property as her place of residence simultaneously. The appeal was therefore dismissed and a costs order in the amount of $6,000 was imposed.

Salaries Tax – D17/17, D20/17, D21/17, and D24/17

Professional Subscriptions – D17/17

The Taxpayer was employed as a physicist. He sought deductions from his assessable income for the 2015/16 year of assessment for the membership subscriptions he paid to four professional associations in the UK and the US. The advertisement for his job showed that an applicant had to either hold a master's degree in physics or engineering or be a corporate member of the Institute of Engineering and Technology of Hong Kong or the UK. He qualified as he was a corporate member, but this requirement was not specified in his employment contract. A physicist is not a profession which requires registration in Hong Kong, and therefore the Taxpayer could continue in his job and earn the income without being a member of a professional association. The Taxpayer's employer also confirmed that it was not a condition of his job that he continue holding membership of any professional association or incur any professional subscriptions. The Inland Revenue Department (the Revenue) had offered an extra-statutory concession that the Taxpayer would be allowed deduction of the subscription paid to one professional association, but he had refused this offer. His objection was rejected by the Deputy Commissioner and he appealed to the Board, arguing that 1) the subscriptions were prepayments and should be considered as expenses incurred for the performance of his job duties; 2) the subscriptions he paid were not to qualify him to earn his income; and 3) the Revenue's stance in DIPN No.9 (Revised) was not tested in court.

The Board opined that even when a subscription was actually paid, it would not be deductible under section 12(1)(a) as such. The Taxpayer had to show that the subscription was wholly, exclusively, and necessarily incurred in the production of his assessable income. The operation of section 12(1)(a) was rigid, narrow, and restricted (*Lomax v. Newton* applied). It was not enough that the expenses were incurred in gaining income: they must be necessary for that purpose (*CIR v. Robert* P Burns [1980] considered).

The Board considered that the Taxpayer paid the subscriptions of his own volition. While membership of the four professional associations would allow him better access to information relevant to his job and to communicate with other members with a similar background, it was not objectively necessary for him to perform his duties as a physicist or to produce his assessable income (*Ricketts v. Colquhoun, Brown v. Bullock,* and *Simpson v. Tate* applied).

The DIPNs only set out the Revenue's interpretation and practices. They do not bind the Board or the court. Furthermore, the extra-statutory concession in DIPN No. 9, which allowed deduction of a subscription paid to one professional association where the holding of the professional qualification was a prerequisite of employment and where the retention of membership was of regular use and benefit to the Taxpayer's job duties, was not applicable to this case. The Board dismissed the appeal and ordered the Taxpayer to pay costs in the sum of $5,000.

Terminal Payment – D20/17

The Taxpayer was employed by Company A, a private company in Hong Kong. Its ultimate holding company was Company B, a limited partnership in the US. Company A had caused Company B to award the Taxpayer various grants, which consisted of Grant Units in Company B and amounts in a Grant Tax Payment Account. By a letter dated 16 June 2011, Company A terminated the employment of the Taxpayer with immediate effect. Company A filed notifications in respect of the additional payments of $2,715,790 (the First Sum) for the year of assessment 2011/12, which were made to the Taxpayer after he had left the employment. The Assessor raised an additional salaries tax assessment, which was later revised downwards by the apportionment of the payment in lieu of notice (PILON) which was accepted as not taxable under the practice prevailing at that time. The Taxpayer objected to the revised additional assessment, contending that the First Sum was paid to him by way of a compromise and an abrogation of his claims in court proceedings against Company A and hence should not be regarded as income from employment.

The Board found no evidence that the First Sum related exclusively to termination or partnership payments for compensation of the loss of the Taxpayer/Partner's Grant Units in Company B following the termination of his employment. In fact, it was the Second Sum of the same amount which was paid in relation to this having regard to the relevant clauses in the Settlement Agreement and Partnership Separation Agreement (SA and PSA).

On the basis of the correspondences exchanged between the parties regarding the negotiation of the settlement and the provisions under the SA and PSA, it was beyond doubt that the First Sum was paid in settling the claims of the Taxpayer on the basis of his employment contract with Company A or the breach of the Employment Ordinance on the part of Company A. The bonuses or commission, PILON, and leave pay (being part of the First Sum) were payable to the Taxpayer in relation to his past services provided to Company A as an employee and were not paid in consideration of his agreeing to surrender or forgo or abrogate any of his pre-existing contractual rights (the test in *Fuchs v. CIR* [2011] adopted).

As the First Sum was paid to the Taxpayer after the cessation of his employment with Company A, it was deemed to have accrued to him on his last day of employment (i.e. 16 June 2011) according to section 11D(b) proviso (ii).

The Taxpayer also sought to claim a deduction of various items, including legal fees relating to court proceedings of $1,462,647 (Agreed Costs), under section 12(1)(a). The Board found no reason or logic why these other claims should be deductible from the First Sum. The legal costs were not incurred in the performance of the Taxpayer's employment duties and did not satisfy the stringent requirements of section 12 (1)(a) for deduction (*CIR v. Robert P Burns* [1980] applied). In fact, the Taxpayer had received the Agreed Costs from Company A / Company B and suffered no loss.

The Board considered that the Taxpayer earned a substantial annual income and was well educated. He should have the knowledge and ability to differentiate between an appeal with merit and an appeal without merit. Apart from advancing an argument without evidence, he had also twisted the facts to suit his argument. The true fact, as found by the Board, was that he was paid the Second Sum for entering into the PSA (agreed as not taxable). Yet, he refrained from mentioning the Second Sum in his argument and instead tried his best to impress the Board that the First Sum was for that purpose and hence that the First Sum was not taxable. The Board ruled that this appeal was frivolous and vexatious and ordered the Taxpayer to pay $10,000 as costs.

Additional Assessment – D21/17

The Taxpayer filed his Tax Return – Individuals for the year of assessment 2011/12 enclosing a copy of the employer return. He declared his employment income of $1,641,950, and in Part 4.2 of the Return, he declared "as enclosed" without entering the required details and the rental value of the place of residence provided by his employer. On 5 October 2012, the Assessor raised a salaries tax assessment based on the income declared. Upon review of the case, the Assessor found that the rental value of the place of residence should also be chargeable to salaries tax and an additional assessment was issued on 29 May 2015.

The Taxpayer objected to the additional assessment on the grounds that he visited the Revenue in early 2014 upon retirement and after a discussion with an officer, his tax liability was finalized and he made the final tax payment. The gist of the Taxpayer's position was as follows: 1) he had filed a correct tax return; 2) on the basis of that tax return, the Assessor had issued a final assessment and he had paid that amount; and 3) he then went to the Revenue, where he tried again to confirm that the tax had been paid and payment was confirmed. So, in such circumstances, he should not have to pay the extra tax.

The Board was satisfied that the Taxpayer had disclosed the rental income in the attachment to the tax return and as part of the tax return filed. However, section 60(1) empowers an assessor to raise additional assessment on any person who appears to have been assessed at less than the proper amount for a particular year of assessment, with the statutory time limit of 6 years after the expiration of the year of assessment (*Indeed In Hossack v. IRC* [1974] followed). If any person wants a binding agreement or a ruling on his tax position, the procedure as laid down in section 88A(1) must be followed. The Taxpayer in this case had not made such an application. The Board found that the 2014 meeting, even as portrayed by the Taxpayer, was an informal affair and no binding agreement permissible under the Ordinance concerning the Taxpayer's tax position could have been made. Even if there had ever been a misrepresentation of the Taxpayer's tax position by the Revenue upon which the Taxpayer relied, this could not as a matter of law preclude further assessment by the Board, which the Board was duty bound to do (*Aspin v. Estill (Inspector of Taxes*) [1987], *Nina TH Wang v. CIR* [1994], and *Hossack v. IRC* [1974] followed).

Source of Employment – D24/17

On 9 June 2010, the Taxpayer accepted an offer from Company E, a Hong Kong subsidiary of Company A1 headquartered in Country D, after being interviewed in Country D and signing a contract in Shanghai (the HK Contract). On 6 July 2010, she reported for duty at Branch G2 and signed another employment contract in Chinese with Company F, a Mainland subsidiary of A1, which stated in the first sentence that the Taxpayer's labour relationship with Company E was terminated on 6 July 2010 (the SH Contract).

On 16 December 2013, the Taxpayer was asked to resign and was presented with a letter by which Company E accepted her resignation from the company. The Taxpayer pointed out that 1) she rendered her services exclusively in Shanghai, 2) her salary and bonus were paid to her by Company F, 3) she paid individual income tax and produced the payment certificates, and 4) there were seven occasions during her visits to Hong Kong when she did "work" as opposed to purely personal pursuits. The Assessor found out from the Immigration Department that she was in Hong Kong for 82 days during the period from 1 July 2010 to 31 March 2011, and adopted a "day out" formula to apportion the income for exclusion from tax.

The Taxpayer appealed against the Deputy Commissioner's determination in respect of the salaries tax assessment raised on her for the year of assessment 2010/11, arguing that her employment was a non-Hong Kong employment, or alternatively that her income fell within the exemption under section 8(1A)(c).

The Board rejected the argument that the Taxpayer's employment was a non-Hong Kong employment. It was clear that Company E was designated by the group as the Taxpayer's employer in law. The Board did not accept that the first sentence in the SH Contract was sufficient to terminate the HK Contract and it was not binding on Company E. While the SH Contract contained provisions for the Taxpayer's remuneration and benefits consistent with the HK Contract, it lacked the extensive provisions (e.g. restriction regarding confidential information) that one would expect to find in a contract for someone in senior management. The Board found that at all material times, the Taxpayer was employed under the HK Contract, although she was sent to head Branch G2. Given the terms of the HK Contract, the Board had no doubt that she had a Hong Kong employment and that the source of her income was Hong Kong.

While the Taxpayer was interviewed in Country D, the place of negotiation was only one of many facts that needed to be considered. The Board believed it was only significant where one or more of the contracting parties were non-Hong Kong residents or entities, which was not the case with the HK Contract.

The fact that the Taxpayer rendered her services exclusively in Shanghai was relevant in considering whether the exemptions in sections 8(1A)(b) or 8(1A)(c) were applicable but not relevant in the enquiry into the source of income (*CIR v. Geopfert* [1987] and *Lee Hung Kwong v. CIR* [2005] referred to). A person could be under a Hong Kong employment and yet render his services wholly or partly outside Hong Kong.

The Board opined that the Assessor had confused the "60 days rule" with the "day in day out formula". It was held that 1) the Taxpayer was liable to salaries tax in Hong Kong not because she was in Hong Kong for more than 60 days but because her employment with Company E was a Hong Kong employment; 2) while the "60 days rule" was relevant in deciding whether her income was exempt from tax by virtue of section 8(1A)(b), she had visited Hong Kong for 82 days; and 3) her monthly salary and bonus could be excluded from tax under section 8(1A)(c) because all three requirements were satisfied (i.e. the income was derived from services overseas; the income was chargeable to tax of a similar nature to salaries tax; and the Commissioner was satisfied that the person had paid tax in that territory). However, none of these requirements had any correlation with the number of days the Taxpayer might fortuitously happen to be in or out of Hong Kong. The Board remitted the case to the Commissioner to determine if "other allowances" would also satisfy section 8(1A)(c) for exemption.

Appeal Out of Time – D13/17

The Appellant was a company incorporated in Hong Kong with its shareholders and sole director residing in Europe but its company secretary and tax representative residing in Hong Kong. The Deputy Commissioner's determination was sent to the Appellant's registered office in Hong Kong by registered post, with a copy sent to its tax representative, who acknowledged receipt and transmitted the same to the Appellant's formation agent in Europe. The Appellant's company secretary also received the determination and transmitted it to the Appellant's registered office and formation agent in Europe. However, no notice of appeal was received from the Appellant until 22 May 2017, outside the statutory period of one month for the lodging of an appeal. Furthermore, despite reminders being given by the Clerk to the Board as to the date and time of the appeal hearing, the witness(es) to be called, and the attendance of the Appellant's representative, the Clerk did not hear from the Appellant until 13 September 2017, when its director confirmed that he would not be able to attend the hearing, the company's tax representative could not represent it, and the company's lawyer in Europe would not be available. Neither the Appellant's director nor its authorized representative attended the appeal hearing. The Appellant also made no application to postpone or adjourn the hearing or to proceed to hear the appeal in its absence.

The Board was not satisfied that the Appellant's failure to attend the hearing was due to sickness. It had been given ample time and reminders to arrange for its director or authorized representative to attend the hearing. In such circumstances, the busy business schedule of its director, the unavailability of its lawyer in Europe, or the alleged incompetence of its Hong Kong tax representative could not constitute reasonable cause for its absence from the hearing. The appeal was dismissed.

Penalty Tax – D18/17

The Taxpayer was required to furnish a return by the extended deadline of 15 August 2016. On 18 August 2016, it submitted the return together with the profits tax computation for the year ending 31 December 2015. Not until 28 September 2016 were the audited financial statements (dated 7 July 2016) received by the Revenue. The valid return was filed late by 44 days. The Taxpayer sought to explain that this was due to a delay in the finalization of the audited financial statements because of the need to include share-based payments made to employees in accordance with the Hong Kong Financial Reporting Standards. The tax representative submitted as "reasonable excuse" that 1) the Revenue had suffered no loss due to the failure to submit the valid return on time, 2) the Revenue had not suffered from any failure to detect the Taxpayer's liability, and 3) the Taxpayer had made its best attempt to submit the return and had no intention to delay the filing wilfully.

The Board opined that it could not be an excuse for the Taxpayer to claim that *subsequently* it turned out that the Revenue was able to issue the profits tax assessment in a timely manner and that the amount of assessment was one that had been covered by the provisional tax paid previously. Section 82A empowered the Commissioner to assess additional tax on the assumption that the failure to file the tax return had not been noticed (*D31/94* followed). Lack of intention to delay the filing of tax return wilfully was not a reasonable excuse. The exercise of best efforts on the part of the Taxpayer's directors, its auditor, and its tax representative was of no assistance to the Taxpayer (*D112/99* followed).

In determining whether the additional tax assessed was excessive, the correct approach was to look at the additional tax as a percentage of the amount of tax involved. The Commissioner acted reasonably in taking into account the fact that the Taxpayer had a record of not furnishing its profits tax returns on time in the previous four years. The continuing contributing factor to this, namely the difficulty of communicating with and obtaining the signatures of the directors who were operating offshore, was suggestive of a lack of motivation on the part of the Taxpayer and those taking care of its auditing and tax affairs to put its house in order *(D16/96* followed).

Previous Board decisions had suggested that a starting point of 10 per cent of the amount of tax that would have been undercharged was appropriate for a first offender, where the delay was unintentional and the Revenue had suffered no loss. Yet, the Commissioner had maintained the assessment at a level below 7 per cent for the present occasion. The Board confirmed the additional tax assessment and ordered the Taxpayer to pay $5,000 as costs because the Taxpayer's appeal was found to be frivolous and vexatious.

Profits Tax – D16/17, D19/17, D22/17, and D23/17

Source of Profits – D16/17

The Taxpayer purchased goods (semi-finished products and consumables) from its related Hong Kong entities and sold the finished goods to its related Hong Kong entities. The goods were manufactured by Mainland entities under a contract processing and assembly agreement.

The Taxpayer claimed that all its business operations, including sales, purchases, and manufacturing, were completely carried out in the Mainland. Hence, the profits derived from the sale of goods were offshore in nature and non-taxable.

On the basis of the evidence from the audited financial statements that the Taxpayer had purchased from and sold goods to related Hong Kong parties in which the Taxpayer's directors had beneficial interest, the Board was of the view that the Taxpayer did carry on its business in Hong Kong. The related parties' audited financial statement showed that they all had places of business in Hong Kong. Other relevant evidence included the following:

1. The Taxpayer has maintained a business registration in Hong Kong since 2003 (year of commencement of business). At all relevant times, it operated its business from a Hong Kong address.

2. During the relevant years of assessment, one director of the Taxpayer returned to Hong Kong from time to time, and two directors had residential addresses in Hong Kong.

3. The Taxpayer opened bank accounts with Bank N in Hong Kong.

4. The Taxpayer employed staff in Hong Kong and filed employer's returns for them. According to the statement of travel records, one staff member returned to Hong Kong from time to time during the relevant years of assessment.

5. The Taxpayer had stated in its reply to the Inland Revenue Department that its staff in Hong Kong 1) received mails and cheques (sale proceeds); 2) deposited cheques into its bank account in Hong Kong; 3) handled matters relating to the bank account; and 4) withdrew money from the bank account and transferred it to the Mainland (for settlement of expenses).

The Board found the Taxpayer's claim that it carried on business in the Mainland was unsupported by evidence. The Taxpayer neither had a business licence nor maintained any office in the Mainland. Also, it did not have any tax registration in the Mainland.

As to the source issue, the Taxpayer primarily argued that it was engaged in manufacturing watch cases and watch bands and straps and focused on OEM (Original Equipment Manufacturing) and that all its business operations, including sales, purchases, and manufacturing, were completely carried out in the Mainland. However, the Taxpayer was unable to provide any evidence of a representative transaction. The contract processing and assembly agreement and the renewal agreement were signed between the Mainland entities and Company K. The Taxpayer had never signed any processing agreement with any Mainland party.

The Board held the Taxpayer had failed to discharge the onus on it to prove that all its business operations, including sales, purchases, and manufacturing, were completely carried out offshore in the Mainland. Therefore, the appeal was dismissed and a costs order in the amount of $20,000 was imposed.

Property Transactions – D19/17 and D23/17

In **D19/17**, the Taxpayer was a private limited company incorporated in Hong Kong in 1987. During the years ending 31 March 2011 and 2012, the Taxpayer's issued share capital was $10,000. In its director's report for the years ending 31 March 2011 and 2012, its principal activity was stated as properties letting.

By a provisional agreement for sale and purchase dated 3 November 2010, the Taxpayer, through Company E, agreed to purchase Shop F at a consideration of $13,050,000. The purchase was completed on 11 January 2011.

By a provisional agreement for sale and purchase dated 16 April 2011, the Taxpayer, through Company G, agreed to sell Shop F at a consideration of $18,000,000 to Purchaser H. The formal agreement for sale and purchase was executed on 3 May 2011. The sale was completed on 8 August 2011.

Shop F was purchased and sold with an existing tenancy. During the years ending 31 March 2011 and 2013, the Taxpayer sold other properties (i.e. Shop J and House K). It was found by the Board that Shop F was offered for sale in December 2010, even before Shop F was assigned to the Taxpayer in January 2011.

The Taxpayer submitted that the disposal gain was capital in nature on the following grounds:

1. The intention to purchase Shop F was for long-term investment. Shop F was subsequently disposed of due to changes in environment.

2. The Commissioner of Inland Revenue had not provided concrete evidence to support the argument that the Taxpayer purchased Shop F with an intention to sell. In contrast, the Taxpayer's history revealed that it had never purchased property for sale.

3. The Commissioner relied on the short interval between the purchase and sale to support his conclusion. The history and the subsequent events confirmed that the Taxpayer had never carried on a trading business.

The Board held that the question of whether something amounted to the carrying of a trade was objective and required an examination of all the circumstances (*Lionel Simmons Properties Limited (in liquidation) and* *others v. CIR* [1980]; *All Best Wishes Limited v. CIR* [1992]; *Brand Dragon Limited (in members' voluntary liquidation) and other v. CIR* [2001]; *Marson v. Morton* [1986]; *Lee Yee Shing v. CIR* [2008]; *Real Estate Investments (NT) Limited v. CIR* [2008]; *and CIR v. The Board of Review, ex parte Herald International Limited* [1964] followed).

The Board opined that a self-serving statement of intention was not sufficient to establish that there was a change of intention and that such a change of intention must have been established with reference to all relevant circumstances (*Lionel Simmons Properties Limited (in liquidation) and others v. CIR* [1980] followed).

Also, the onus of proving that the assessment was excessive or incorrect was on the Taxpayer. The actions taken by the Taxpayer, including its quick offer for sale before the assignment and active pursuit of a higher price afterwards, contradicted the alleged intention of acquiring Shop F for long-term investment.

The Board took the view that the Taxpayer purchasing Shop F and selling it afterwards with the same existing tenant producing rental income was a neutral factor. Borrowing money for acquisition was another neutral factor (*Real Estate Investments (NT) Limited v. CIR* [2008]; *and Lee Yee Shing v. CIR* [2008] followed).

The Board held that the gain on the disposal of Shop F was trading in nature and dismissed the appeal.

In **D23/17**, the Taxpayer and her husband ('Mr C') were married in December 2010, and their daughter was born in 2012. On 4 July 2010, the Taxpayer purchased Property A, with the conveyance made on 9 April 2011. At the time of acquisition, Property A was still under construction. The Taxpayer never resided in Property A but rented it out instead. The Taxpayer and her family resided in a rented apartment. On 12 August 2012, the Taxpayer sold Property A (with the conveyance made on 27 September 2012) and obtained a profit of $3,145,259. On 13 January 2013, Mr C purchased Property J, and the conveyance was made on 30 April 2013.

The Taxpayer did not report the profits derived from sale of Property A in her tax return and appealed the Deputy Commissioners' determination on the following grounds:

1. Her intention at the time of purchasing Property A was for self-use. However, her intention changed after she took possession of Property A following her marriage and pregnancy, as she found that the space was too small.

2. She sold Property A and applied the proceeds to acquire Property J under the name of Mr C.

3. The listing of Property A for sale was due to frequent enquiries by estate agents and her own curiosity to know the market price.

4. She and Mr C only had one property (i.e. Property J) and had no intention to engage in speculative activity.

During the appeal hearing, the Taxpayer submitted to the Board copies of Mr C's and her own bank statements but later withdrew the documents as she could not explain how they were relevant to her claim that she applied the proceeds of the sale of Property A towards the acquisition of Property J.

The Board considered the following badges of trade in ascertaining the Taxpayer's intention:

1. Frequency with which the Taxpayer engaged in similar transactions

2. Length of ownership period

3. The asset's "fitness" for trading or investment

4. Quantities of the same commodity or asset purchased by the Taxpayer

5. Whether the Taxpayer had the intention for resale at the time of acquisition of the asset, and whether her reason existed when she sold the asset

6. Maintenance and supplementary work done to increase the value of the property

7. Whether the Taxpayer expended time, money, or effort in selling the asset or commodity that went beyond what might be expected of a non-trader seeking to sell an asset

8. Actual intention to resell at a profit at the time of acquisition

9. Whether the asset or commodity was purchased for personal use or pleasure or for income (*Lionel Simmons Properties Limited (in liquidation) & Others v. CIR* [1980], *All Best Wishes Ltd v. CIR* [1992], *Lee Yee Shing v. CIR* [2008] considered)

The Board was of the view that the Taxpayer and Mr C must have been clear about whether Property A was suitable for their use as a married couple and after having a baby before it was acquired. Before the conveyance, the Taxpayer had already decided to sell or rent out Property A. The Board also opined it was unbelievable that she found that Property A was too small (and decided to sell it or rent it out) after she obtained possession. Further, the fact that the Taxpayer repeatedly adjusted the listing price of Property A reflected her intention to sell Property A in order to obtain profits from investment, not merely out of her curiosity about the market price. There was no evidence that the Taxpayer had applied the sale proceeds of Property A towards the acquisition of Property J.

The Board concluded the Taxpayer purchased Property A with the intention to trade and that the said intention did not change when she subsequently sold Property A. The sale of Property A was trading in nature and the profits so obtained should be assessable to profits tax.

Lending Money Constitutes Business – D22/17

In **D22/17**, the Taxpayer was a company incorporated in Hong Kong with Hong Kong resident shareholders. In 2003, it agreed to subscribe for shares in another company (Company G), and as part of the same agreement ("Subscription Agreement"), it also agreed to extend a loan to Company G. In 2006, the Taxpayer agreed to advance another loan to Company G. The loan transactions were executed through bank accounts maintained with banks in Hong Kong. Both loan agreements were said to be governed by Hong Kong law. The Taxpayer claimed that the loans were advanced in the Mainland for investment in properties by the recipient company there. The Taxpayer treated the interest income as offshore in nature in its tax returns. The Assessor raised profits tax assessments on the interest income. The Deputy Commissioner confirmed the assessments, stating that the loans were financed by loans obtained from the Taxpayer's shareholders and loans owed to the Taxpayer. This was a strong indicator of the Taxpayer carrying on a business. The Deputy Commissioner also concluded that the source of the interest income was in Hong Kong.

The Deputy Commissioner sent his Determination to the Taxpayer and its tax representative by registered post at their respective addresses on 5 July 2017. Post Office records showed that the registered post was successfully delivered to the Taxpayer's address on 7 July 2017. However, the registered post was not successfully delivered to the tax representative's address as the tax representative was out of Hong Kong at the time. The postal packet for the tax representative was returned as unclaimed on 1 August 2017. On 2 August 2017, the Determination was sent to the tax representative's address by ordinary post and was received on 5 August 2017. The tax representative wrote to the Board on 7 August 2017 to ask for extension of time to lodge an appeal against the Determination. The tax representative gave notice of appeal to the Board on 15 August 2017.

The Board was of the view that given that the tax representative had accepted that the notice of appeal was given outside the 1-month period provided by section 66(1)(a) of the IRO, it was for the Taxpayer to give evidence to show any reasonable cause for the delay, as it was not prevented from giving the notice within time by illness or absence from Hong Kong. As the Taxpayer did not put forward any evidence, and it was plainly insufficient for the tax representative to make assertions for it, there was no reasonable cause to extend the time for lodging the notice of appeal. In any event, the Taxpayer could not rely on communication difficulties with its tax representative or the incompetence and/or negligence of the tax representative to argue that it was prevented from lodging the notice of appeal within the statutory time limit (*Chow Kwong Fai v. CIR* [2005] followed). Specifically, the word 'prevented' in section 66(1A) should best be understood in terms of the Taxpayer being 'unable to' comply with section 66(1). This understanding imposes a higher threshold than a mere excuse. The word 'prevented' was said to be "opposed to a situation when an appellant is able to give notice but failed to do so". The Board therefore rejected the application for an extension of time to lodge the notice of appeal.

Notwithstanding that the extension of time to lodge an appeal was rejected, the Board still considered the substantive merits of the case. The Board held that the Taxpayer did not argue that the interest income was not derived from Hong Kong, and it was correct for the Deputy Commissioner to conclude that the Taxpayer carried on a business in Hong Kong. The Taxpayer put its assets to gainful use by lending them to another company, and the interest derived represented the gains from such use. Hence, section 15(1)(f) deemed the interest income to be derived from a business carried on in Hong Kong (*American Leaf Blending Co Sdn Bhd v. Director of Inland Revenue* [1979], *CIR v. Bartica Investment Ltd* [1996], *D44/04* followed). The Taxpayer did not adduce any evidence to contradict the prima facie conclusion and could not simply rely on the tax representative to assert the background and circumstances of the loan agreements.

The Taxpayer's representative had tried to argue that the substantive nature of the interest income was dividend income. To show that the loans were in the nature of investments and the interest payments were in the nature of dividends, the tax representative relied on the terms of the Subscription Agreement, the 2003 Loan Agreement, and the 2006 Loan Agreement, particularly the exclusion of non-performance or non-observance of the terms and obligations on making payments from being one of the events of default, as well as the freedom that Company G had in deciding when the principal and/or the interest of the loans would be repaid.

However, the Board did not accept that these submissions overcame the *prima facie* application of section 15(1)(f). This was because the 2003 Loan Agreement and the 2006 Loan Agreement had specific terms defining the interest calculation, the interest rate, the repayment arrangement, and the provision for an enhanced rate of interest in default. These terms had to be observed when an interest payment was made. Thus, these two loan agreements had settled the return or the parameters of the return the Taxpayer would receive for the loans advanced to Company G, and such a return, as the Revenue had submitted, was interest, not distribution of profits, and therefore could not be regarded as a dividend.

The Board dismissed the appeal and held that the interest income was chargeable to profits tax.

Observation

It is interesting to note that the Board in **D22/17** took a very 'lenient' approach in considering whether the Taxpayer had carried on business in Hong Kong. However, the IRD took a rather 'stringent' approach in considering whether a person carries on a "intra-group financing business" in DIPN No. 52, where the IRD, with reference to *Shun Lee Investment Co. Ltd. v. CIR* [1967] and *CIR v. Chinachem Finance Co. Ltd*. [1993], states the following principles:

"(a) the frequency, repetitiveness, and the amount of the borrowing from and lending to associated corporations of money;

(b) whether there is borrowing from and lending to associated corporations of money at commercial rates of interest;

(c) whether there is a degree of system and continuity of laying out and getting back the loan of money by way of interest and repayment of principal;

(d) the regularity and frequency of the payment of interest and repayment of principal;

(e) whether a profit is earned out of the interest differential between the borrowing and lending; and

(f) whether the interest charged on the borrowing and lending is on an arm's length basis."

The IRD also states:

"to constitute intra-group financing business there should be sufficient number of intra-group borrowing and lending transactions with a number of associated corporations, involving not an insignificant amount of funds having regard to the nature and scale of the business operations of the multinational corporation. Generally, the Commissioner would accept that a corporation is carrying on an intra-group financing business if:

(a) the corporation has not less than four borrowing or lending transactions each month;

(b) each borrowing or lending transaction exceeds $250,000; and

(c) borrowing or lending transactions are with not less than four associated corporations in the relevant basis period."

The meaning of "business" and "intra-group financing business" might be different. But whether the difference is as wide as the approach adopted in D22/17 and DIPN No. 52 might be questionable. Unfortunately, the Taxpayer and its representative in D22/17 did not raise the issue for debate in the hearing. T