additional amount was not part of the sale price; nor was it simply paid for the enhancement of a capital asset. Rather, it was paid for the taxpayer agreeing to participate in the joint venture. When the taxpayer agreed to participate in the joint venture, the court found that it changed its intention from holding the premises as a capital asset by substitution with a trading asset.

(6) *Church Body of Sheng Kung Hui v CIR* [2010] HKC 475. Reyes J ruled that the Church had changed its intention from holding land as a capital asset to embarking upon a trade when it decided to redevelop the land on which it previously ran an orphanage into a private residential estate by way of a joint venture with a developer. The date picked as being the date of change of intention was, however, contentious as the Church was not contractually bound to proceed with the planned redevelopment until 3 years after that date. The case is currently on appeal (CACV 41/2010) and is scheduled to be heard in October 2013.

D. MEANING OF 'BUSINESS'

1. Definitions

It is clear from the above discussion that the concept of trade is a wide one. Yet, as a general matter, the common law meaning of business is even wider: see *Lee Yee Shing v CIR* [2008] 3 HKLRD 51; FACV 14/2007 (January 2008), per Bokhary and Chan PJJ at paragraph 17 and McHugh NPJ at paragraph 68). In *Rangatira Ltd v CIR (NZ)* [1997] STC 47, 56 the Privy Council stated: 'the term "business" itself when used in the context of a taxation statute, is the fundamental notion of the exercise of an activity in an organised and coherent way and one which is directed to an end result' (quoted with approval by McHugh NPJ at paragraph 69 in *Lee Yee Shing*, a case in which the judge extensively examined the meaning of business in relation to an individual's share dealing activities). Usually, however, it is unnecessary to concern oneself with this matter because it is normally clear whether or not a person carries on a trade or business.

Lee Yee Shing v CIR

Court of Final Appeal [2008] 3 HKLRD 51; FACV 14/2007, paras 72–73

MCHUGH NPJ (RIBEIRO PJ AND POWER NPJ AGREEING): Seldom is it difficult to determine whether an incorporated body or partnership is carrying on a business – at all events when the relevant activities of that body or partnership are carried on with the object of making gains or profits. Nor is it often difficult to determine whether an individual is carrying on a business when that person is

engaged full time in activities that are normally regarded as a business rather than a pastime or hobby. But questions of great difficulty often arise when individuals pursue activities that are normally regarded as a recreation, hobby or entertainment and do so in the certainty, hope or expectation of making gains or profits. Most sporting activities, recreational games and gambling activities fall into this category. The activities of a football or tennis player, a chess master or a bridge player, a photographer or a horse or dog bettor may each constitute a business although similar activities carried out by millions of others are no more than a pastime, hobby or recreation. To determine on which side of the line, the activities of a particular individual fall is often a difficult question.

Even more difficult to determine are those cases where, on a casual, temporary or part time basis, individuals pursue activities that, as a matter of common experience, are normally regarded as constituting a business, trade or profession. The difficulty of determining whether such individuals are carrying on a business is increased when, as is often the case, they do so with the hope or expectation of gain or profit. Share trading is an activity that falls into this difficult class. As the Board of Review pointed out *CIR v Dr Chang Liang-Jen* (1977) 1 HKTC 975 at 984–985:

> The difficulty that arises in the case of purchases and sales in the Stock Exchange and whether such transactions constitute a business or adventure in the nature of trade stems from the recognition that in the post-war years of the world today it is common to find persons in every walk of life employing money surplus to their needs or a part of it in the purchase of quoted shares. In so doing, the primary consideration of an investor is not necessarily related to the dividend or income yield but the preservation and growth of his capital in this day and age where inflation is constantly on the rise. As the financial health of companies may vary from time to time according to economic needs or prevailing situations, a shrewd investor may consider switching investments which he thinks will give him more security or bring him a better return either in dividend or in growth. Changes in share investments or realisation of stock securities are, therefore, features which one can expect not only in the case of a trader but also in that of an investor.

[In the event, McHugh NPJ concluded at paragraph 44 that it was reasonably open to the Board to find that the taxpayer's dealings were not so systematic and organised that they amounted to the carrying on of a trade or business.]

As indicated above, United Kingdom tax cases have concentrated on the meaning of trade rather than business – 'trade' is the term used in Schedule D of the Income and Corporation Taxes Act 1988. However, United Kingdom cases do consider the definition of business in the context of the Partnership Act, because partnership is defined therein as the relationship of persons 'carrying on business' with a view to profit.

In *Lam Woo-shang v CIR* (1961) 1 HKTC 123, 140, the court quoted the following definition of business in *Smith v Anderson* (1880) 15 Ch D 258:

> 'business' is a word of large and indefinite import … It is a word of extensive use and indefinite signification … the Legislature could not well have used a larger word.

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Thus, care should be taken when applying in Hong Kong the United Kingdom cases on trading – for even if there is no trade, there may still be a liability to profits tax if a person carries on business.

Business is defined as follows in s 2(1) of the Inland Revenue Ordinance:

> 'business' includes agricultural undertaking, poultry and pig rearing and the letting or sub-letting by any corporation to any person of any premises or portion thereof, and the sub-letting by any other person of any premises or portion of any premises held by him under a lease or tenancy other than from the Government.

The following definition of business appears in s 2(1) of the Business Registration Ordinance (Cap 310, LHK): 'any form of trade, commerce, craftsmanship, profession, calling or other activity carried on for the purpose of gain and also means a club.' There is no legal reason for using this definition for profits tax purposes, although in practice it may be useful because the Business Registration Ordinance is administered by the Commissioner of Inland Revenue. Also as a practical matter, the fact that a person has applied for a business registration certificate may be relevant in determining whether that person is carrying on business, but it is certainly not determinative of the issue: see, eg, *D 122/02* 18 IRBRD 135 and *D 14/09* 24 IRBRD 438.

2. Letting of property

The definition of business in s 2(1) of the Inland Revenue Ordinance, above, has two limbs. The first deals with certain farming activities and is self-explanatory. The second deals with the letting of property and is designed to overcome the rule that at common law, the mere letting of property does not constitute a business. The definition therefore provides that any corporation that lets property is deemed to carry on business, and that any other person, such as an individual or trustee, that *sublets*, and not merely lets, is also deemed to carry on business.

What is the position of an individual who lets property? That person is not deemed to carry on business. However, s 2(1) does not define the only cases where a person carries on business. The use of the word 'includes' makes this clear. Thus, if an individual who lets property carries on business in the normal sense of the word, liability to profits tax may arise under s 14.

Kwong Kwan-nang, Louis v CIR
Court of Appeal (1989) 2 HKTC 541, 572–573

Two brothers let out a cinema. They continued as the licence holder and imposed a condition in the lease, that the lessee, who was the cinema operator, would do nothing to affect the goodwill attached to the cinema and the licence to operate it. The lease also included certain fittings, fixtures and equipment. The question before the court was whether the brothers carried on a business – even though they were not deemed to carry on business by virtue of s 2(1).

MACDOUGALL JA: In my view the relevant part of the definition of 'business' does no more than provide that the mere subletting by a [Government] lessee [which is not a corporation] of the property which is the subject of the [Government] lease does not of itself and without more come within the meaning of 'business'.

That brings me to a consideration of whether the activity in which the taxpayers engaged could properly be described as the carrying on of a business. Can it reasonably be said that this was something more than the passive receipt of rental from property in circumstances not amounting to the carrying on of a business? …

The taxpayers did not simply require that the premises be returned to them in good condition at the expiration of the tenancy but were concerned that the goodwill attached to the cinema and the licence to operate it would remain unaffected. In my view the Board arrived at an entirely reasonable conclusion that what was done went beyond the mere letting of premises and constituted the letting of a cinema as a going concern … The entire transaction of letting the cinema, fixtures, fittings and equipment for the application of a public cinema together with the benefit of a licence to operate it can reasonably be said to amount to a business transaction.

Apart from the deeming provisions in s 2(1), when does a person carry on business by letting property? A hotelier and cinema owner clearly do, but a person with a vacant flat who finds a long-term tenant clearly does not. Where is the borderline?

Lam Woo-shang v CIR
Court of Appeal (1961) 1 HKTC 123, 145 and 149

The taxpayer purchased property and redeveloped it into residential units. She sold 19 of the units, kept 12 for rental purposes and retained one unit as a personal residence. Before leasing the 12 units, the taxpayer furnished them. She paid the electricity and gas bills and was reimbursed by her tenants. Her husband collected the rents.

HOGAN CJ: Turning then to the question whether the appellant was properly held to have carried on a business, it is obvious that a person may carry on a trade or business on property which he owns, just as a person who occupies property under a lease or tenancy may do so. Clearly also there is a fundamental distinction between, on the one hand, the case where what the taxpayer does amounts merely to the passive receipt of the fruits of his proprietary rights as landowner, as by the receipt of rents (vide *Croft v Sywell Aerodrome Limited* [1942] 1 All ER 110), and on the other hand, the case where a landowner embarks upon an undertaking or venture in the nature of a dealing or dealings by way of trade or business in, or with, the property owned by him. We say dealing 'in or with' the property, because it is necessary to distinguish the case where a

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landowner carried on a trade or business on his property – a trade or business which could well be independent of the ownership of any property – from the case where the landowner is asserted to deal in or with his property as, for example, by the letting of offices, which was alleged to be a 'trade' in *Fry v Salisbury House Estate Ltd* [1930] AC 432, or by granting licences for entertainment purposes, as in *Coman v Governors of the Rotunda Hospital, Dublin* [1921] 1 AC 1 … and the cases where the taxpayer is asserted to have entered upon the trade or business of buying and selling property …

At what point then, in the case of an individual, does 'investment' in land and buildings cease and the 'business' of letting such property commence? The Board found that the Appellant was driven to providing furniture because she was experiencing difficulty in letting the flats unfurnished. On this aspect of the matter the case of *West v Phillips* (1958) 38 TC 203, is authority for saying that such a change of intention, forced upon the taxpayer by circumstances, excludes a finding that the taxpayer has embarked upon, as a business venture, the activity to which he or she is ultimately driven by the change of circumstances. We consider that the Board placed undue emphasis upon the matter of the furnishing of the flats in arriving at its determination that what the Appellant did amounted, in law, to carrying on a business. We cannot perceive that the provision of furniture for the purpose of facilitating the letting of property, in itself, converts the case from one of ordinary investment to one of carrying on a business. If the decision whether the Appellant had embarked upon the business of letting flats were to have rested upon English decisions alone then the case might well have been a border-line one. From one point of view, the Appellant acted no differently from the manner in which any ordinary landowner would act, namely, in turning her property to account in the normal way in which landed property is turned to account, that is to say by letting it at the best rent. If the taxation net is to be cast so wide as to embrace furnished lettings on the basis that amounts to a business then anyone who invests his money in the purchase of landed property and then proceeds to turn it into account in the ordinary course, as by letting it, furnished if necessary to facilitate the lettings, is to be held to be carrying on a business. It is no answer, in our view, to the question posed above, as to when 'investment' ceases and the 'business' of letting commences, to say: 'when the premises are furnished', even if one were to add to that 'to make them more "marketable"'; nor to say: 'when there is a plurality of lettings'. [On this basis, the court decided that the taxpayer was not carrying on a business notwithstanding the large number of units leased. As discussed below, and as a general matter, a mere passive receipt of income does not constitute a business.]

NOTE

The court in *Lam Woo-shang* also found that the taxpayer was deemed to carry on business by virtue of the then definition of business in s 2(1). As a result of the decision, the definition was amended to make clear that it only applied to an individual who was a sub-lessee and not simply a lessee from the Government.

3. Use of a corporate vehicle

Contrast *Lam Woo-shang*'s case with the following case.

American Leaf Blending Co Sdn Bhd v DGIR (Malaysia)
Privy Council [1978] 3 WLR 985, 990

A company abandoned its tobacco business and let out its business premises consisting of a factory and a warehouse. There were successive lettings of the premises over a period of five years. Did the company carry on business?

LORD DIPLOCK: … Their Lordships do not think that the dicta to be found in some of the speeches in *Fry v Salisbury House Estate Ltd* and in particular those of Lord Warrington of Clyffe and Lord Macmillan on which the Federal Court relied and which suggest that the letting of land does not constitute a 'trade', have any relevance to the question whether the letting of land by the company in the instant case amounted to the carrying on of a 'business' … 'Business' is a wider concept than 'trade'; and in the *Hanover Agencies* case [1967] 1 AC 681 the Board uttered a warning against seeking to apply these dicta outside the narrow context of British income tax law and in particular that of Schedule D.

In the case of a private individual it may well be that the mere receipt of rents from property that he owns raises no presumption that he is carrying on a business. In contrast, in their Lordships' view, in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business. Where the gainful use to which a company's property is put is letting it out for rent, their Lordships do not find it easy to envisage circumstances that are likely to arise in practice which would displace the prima facie inference that in doing so it was carrying on a business.

The carrying on of 'business', no doubt, usually calls for some activity on the part of whoever carries it on, though, depending on the nature of the business, the activity may be intermittent with long intervals of quiescence in between. In the instant case, however, there was evidence before the Special Commissioners of activity in and about the letting of its premises by the company during each of the five years that had elapsed since it closed down its former tobacco business. There were three successive lettings of the warehouse negotiated with different tenants; there was the removal of the machinery from the factory area which made it available for use for storage and separate letting of that area to a fresh tenant; and . . . recently there was the negotiation of a letting to a single tenant of both the factory area and the warehouse. [The Privy Council concluded that the company did carry on business.]

COMMENTARY

Whether a company which derives passive income (such as interest) sourced in Hong Kong is carrying on business in Hong Kong has also given rise to a degree of uncertainty as the following case illustrates.

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CIR v Bartica Investment Ltd

High Court [1996] 4 HKC 599, 607–609, 611–612

The taxpayer was a private company incorporated in Hong Kong. It rolled over fixed deposits in Hong Kong and pledged the funds as security for loans made by various offshore banks to finance the operations of the company's offshore associate. The issue was whether the company carried on business in Hong Kong so that interest arising from fixed deposits was liable to profits tax.

CHEUNG J: The authority in this area is *American Leaf Blending Co Sdn Bhd v Director General of Inland Revenue* … . The decision of the Privy Council was delivered by Lord Diplock. The following principles can be extracted from the speech:

(1) Rents may constitute income from a source consisting of a business if they are receivable in the course of carrying on a business of putting the taxpayer's property to profitable use by letting it out for rent.
(2) The question whether the company was carrying on a business of letting out its premises for rent is one of fact.
(3) The Privy Council would not endorse the view that every isolated act of a kind that is authorised by its memorandum if done by [a] company necessarily constitutes the carrying on of a business.
(4) Business is a wider concept than trade.
(5) In the case of a private individual it may well be that the mere receipt of rents from property that he owns raises no presumption that he is carrying on a business.
(6) In contrast, in the case of a company incorporated for the purpose of making profits for its shareholders, any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business.
(7) Where the gainful use to which the company's property is put is letting it out for rent, it is not easy to envisage circumstances that are likely to arise in practice which would displace the prima facie inference that in so doing so it was carrying on a business.
(8) The carrying on of business, usually calls for some activity on the part of whoever carries it on, though, depending on the nature of the business, the activity may be intermittent with long intervals of quiescence in between.

* * *

In the earlier case of *Commissioners of Inland Revenue v South Behar Railway Co Ltd* [1925] AC 476, (1925) 12 TC 657 [in which the taxpayer was taxed on its receipt of annuity payments that were subsequently distributed to its shareholders] … Lord Sumner [in the House of Lords] held that:

(1) To ascertain the business of a limited liability company one must look at its memorandum and see for what business that provides and whether its objects are still being pursued. (*Commissioner of Inland Revenue v Korean Syndicate Ltd* [1921] 3 KB 258, (1921) 12 TC 181) (at 710).
(2) I do not attach much importance to the domestic operations of declaring and paying dividends, remunerating directors and presenting reports, but the operation of receiving and thus discharging the annuity payments goes on continuously, and however simple, it is not a mere passive acquiescence. It is the transaction of business between the debtor and creditor resulting periodically in the discharge of a debt. The present is not the case of a company existing to do one act only and once for all. Not only did the company make the agreement of 1906, but it plays its recurring part in every payment and receipt of gains, and there is here, therefore, that 'repetition of acts', which Brett LJ says (15 Ch D at 277) is implied in 'carrying on business' (at 711).
(3) Business is not confined to being busy: in many businesses long intervals of inactivity occurred (at 712).

* * *

[The business scheme] involved the placing of off-shore deposits, and the pledging of the deposits as securities for the loans advanced by the banks [to the associate company] … . Interest arose out of the deposits and most of the interest earned by the taxpayer was used … to offset interest which was paid by [the associate company]. These clearly show that there was a gainful use of the assets of the taxpayer which, in the words of Lord Diplock, constitutes prima facie a carrying on of a business. If evidence is required for the commercial motive, then the placing of deposits and the furnishing of the deposits as securities are the best evidence one could possibly obtain. Under the memorandum, the taxpayer is entitled to provide security whether with or without consideration. The activities were carried out over a long period between 1984 and 1989 and involving at least two banks. This means that there was a continuous repetition of the business activities. The holding of deposits whether considered on its own or in connection with the giving of securities did constitute the carrying on of a business.

There is nothing from the facts which would displace this inference. On the contrary the evidence serves only to reinforce the prima facie inference that the taxpayer was carrying on business… .

Commissioner's practice following the Bartica case

After the decision in *Bartica* was handed down, the Commissioner immediately issued a revised Departmental Interpretation and Practice Note No 13: 'Profits Tax – Taxation of Interest Received' (revised, December 2004). Whilst accepting that *Bartica* indicates that there is a very low threshold for a company to carry on business, the Commissioner stresses that *Bartica* is not authority for the general proposition that every company holding money on deposit in Hong Kong carries on business in Hong Kong. Each case must still be considered on its individual facts.

The Commissioner states that whether the passive receipt of interest income constitutes the carrying on of business is governed by *IRC v Korean Syndicate Ltd* (1921) 12 TC 181; *South Behar Railway Co Ltd v IRC* (1925) 12 TC 657 and *American Leaf Blending Co Sdn Bhd v DGIR (Malaysia)* [1979] AC 676. From these decisions, the Commissioner concludes that:

- the mere receipt of interest by a company does not constitute the carrying on of business;

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3. To what extent was the expense incurred in the production of chargeable profits?

CIR v Swire Pacific Ltd

Court of Appeal (1979) 1 HKTC 1162

LEONARD J: In 1972, the respondent company ('Taikoo') entered into an agreement with the Hong Kong and Whampoa Dock Company ('Whampoa') whereby the ship-building, ship-repairing and general engineering operations of each company were to be transferred to a new company, to be known as the Hong Kong United Dockyards Ltd ('HUD') in which the two parent companies were each to hold 50 per cent of the shares.

HUD was to come into existence on 1st January 1973, and the intended merger was announced on the 16th September 1972.

Two days later, the majority of the Taikoo labour force went on strike, demanding cash payments, which were referred to as 'retirement grants' and seem to have been the sums which stood to the credit of employees of Taikoo under the latter's retirement scheme.

Most of the workers who went on strike would not have been entitled to receive these retirement grants before the end of 1972, though some of them would.

Taikoo acceded to the strikers' demands and made to them payments totalling $22,416,202, which amount was debited to the staff retirement reserve in the accounts of Taikoo. Taikoo sought to deduct the whole of this amount for the purposes of the assessment of profits tax for Taikoo's financial year 1972 (which covered the same period as the calendar year 1972). The assessor allowed $4,259,454, as properly paid under the approved retirement scheme to workers entitled to receive such payments, but refused to allow the balance of the $22,416,202 (ie $18,156,748).

* * *

What was the purpose for which the payments were made? The Board found that the immediate purpose of the payment was to persuade the strikers to return to work (para 34 of the case stated). This is not disputed, but the Crown argues that the Board was wrong in concluding that the paramount purpose of these payments was the production of profits for the year of assessment 1972/73.

The Board found that, had these payments not been made, various forms of damage of a serious nature would have followed. These included the possibility of sabotage of equipment, the payment of damages for broken ship-repairing contracts, damage to plant and machinery by reason of insufficient maintenance, the loss of business in a competitive market. The company, so the Board found, was influenced by these matters when making payments to the strikers.

In addition, (para 37) the Board finds that one of the elements which influenced Taikoo to settle was the need to have Taikoo operational at the end of 1972 to enable the merger to proceed as planned. The Crown relies on this passage in support of its contention that the Board should therefore have regarded these payments as made, not for the purpose of producing profits, but for the preservation of assets and to safeguard the merger. Alternatively, the Crown argues that, if there was a mixture of purposes, there should be an apportionment and the case should be referred back to the Board for this purpose.

Purpose

A factor creating difficulty in this case was that the purpose of the payment (getting the workers back to work) was clearly regarded by the taxpayers as fruitful of further advantages. Its achievement was necessary before those further advantages could be obtained. While there was only one immediate purpose – to get the workers back to work – the taxpayer was motivated by the further advantages but before those could be achieved the immediate objective had to be realised. The advantages were reasons behind the purpose rather than the purpose itself and the purpose itself could be effected only by payment of the sum and payment of it in its entirety.

Section 16 says the payment shall be deducted 'to the extent to which it was incurred … in the production of profits'. Section 17(1)(b) says it shall not be deducted if it was not 'money expended for the purpose of producing' profits in respect of which a person is chargeable.

In my view, the payment being one to get the business functioning again (albeit only for $3^1/_2$ months in *its then form*) must necessarily have been for the purpose of producing profits chargeable to tax. That the size of the payment was such as to leave it unlikely that profits attracting tax would ultimately be made during that year of assessment is irrelevant. The commercial wisdom of the payment is immaterial. As the judge rightly said:

> Expenditure which is unremunerative is none the less a proper deduction if made with a view to producing profit.

I therefore hold that section 17(1)(b) of the Ordinance does not forbid the deduction of the payment.

NOTES

1. Before apportioning expenditure between deductible and non-deductible components, it should be recalled that s 17(1)(b) denies a deduction for any disbursement or expense, not being money expended for the purpose of producing assessable profits. Many examples where this provision could apply are found in the cases referred to later in this Chapter, including *CIR v Chu Fung Chee* (a barrister incurred legal costs defending a disciplinary action brought against him; the complaint related to his making false statements to HKU for postgraduate admission: *held* – the costs were not incurred for earning the barrister's assessable profits).
2. *Apportionment*. Although no apportionment was possible in *Swire Pacific*, apportionment of expenses is often required under s 16. Note the language of s 16(1): expenses and outgoings are deductible '*to the extent* to which they are incurred … in the production of [chargeable] profits' (emphasis added). An expense may relate to the earning of both chargeable and non-chargeable profits – for example, profits arising partly in Hong Kong and partly outside Hong Kong, or profits which are partly revenue in nature and partly capital in nature. Also, an expense may be incurred partly to produce

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chargeable profits and partly for a non-profit-making purpose. In all of these cases, an apportionment must be made (see, eg *So Kai Tong, Stanley v CIR* [2004] 2 HKLRD 416 and *D 71/97* (1997) 12 IRBRD 410). Rules 2A, 2B, and 2C of the Inland Revenue Rules, and Inland Revenue Departmental Interpretation and Practice Notes No 3, provide guidance as to the proper method of apportionment of expenses in particular instances.

3. *Excessive 'fees' paid to shareholders and associated persons.* Apportionment is appropriate where a taxpayer pays an inflated 'service fee' or 'management fee' to a shareholder or other beneficial owner, either directly or indirectly. See, eg *So Kai Tong, Stanley v CIR* (payments made by a certified public accountant to his associated companies for office premises and equipment increased significantly from the previous year, the amount of those payments was determined retrospectively at end of financial year, and no evidence was presented as to the basis or method of calculation for the payments; held, upholding the decision of the Board of Review that, in accordance with s 16(1) and r 2A, the accountant was only entitled to deduct that part of the payments which was reasonable and appropriate in the circumstances). See also *D 61/91* (1992) 6 IRBRD 457 (dentist paid a management fee equal to most of his income to his wholly owned company, which then paid him various non-taxable fringe benefits as employee compensation; *held*, management fee was partially deductible, by reference to the costs incurred by the company which were directly related to the management services provided: although an appeal was lodged in this case, the stated case was not transmitted to the High Court by the taxpayer).

It should be stressed that expenditure for the purpose of producing assessable profits cannot be disallowed *simply* because it is excessive or not paid on an arm's length basis: see *Ngai Lik Electronics Company Ltd v CIR* (2009) 12 HKCFAR 296; [2009] 5 HKLRD 334. In *Ngai Lik*, the Court of Final Appeal held that payments made to a related company for the purpose of purchasing trading stock were not gifts, even though they were not fixed at arm's length. Ribeiro PJ stated that ss 16(1) and 17(1)(b) 'do not require the IRD to compare the purchase prices [sought to be] deducted against market prices and to disallow deductions considered excessive'. It would, however, be unwise to read too much into this aspect of the *Ngai Lik* decision since it is clear that a deduction for an excessive payment can always be denied if it was not incurred for the purpose of earning *the taxpayer's* assessable profits (eg, where a payment was made to produce both profits for the taxpayer and an associated person – in this case an apportionment would be appropriate). An excessive deduction can also be challenged under the general anti-avoidance provisions of the IRO (ss 61 and 61A), as indeed was the case in *Ngai Lik*. See also *D 41/08* (2008) 23 IRBRD 795 where the Board of Review made the important observation that each company within a group must be treated separately for profits tax purposes and one cannot attribute the overall business expenses of the group or one member of the group to another member simply on the basis of 'economic equivalence'.

4. *Current expenditure, future profits.* Section 16(1) allows deductions for expenses 'incurred during the basis period for [the] year of assessment' to produce profits 'chargeable to tax under this Part *for any period*' (emphasis added). Therefore, it is not necessary to show that an expense actually produced profits in the current year of assessment, or that the expense was intended to produce profits in the current year. As indicated in the *Swire Pacific* decision, it is sufficient if the expense was incurred for the purposes of an ongoing business which produces chargeable profits. See also *W Nevill & Co Ltd v FCT* (1937) 56 CLR 290 (compensation paid for rescission of long-term contract of service for taxpayer company's managing director; *held*, deductible, because rescission was in taxpayer's best interests and reduced future expense) and *Duple Motor Bodies Ltd v Ostime* (1959) 39 TC 537 (relating to the valuation of work in progress which would be sold in a subsequent year of assessment).
5. *Pre-commencement expenses.* It is the IRD's practice to allow pre-commencement revenue expenses to be deducted in the year of commencing a trade or business. On occasions, this result is mandated by specific provisions in the IRO: see, eg, ss 16E(3A) and 16EA(10).
6. *Current expenditure, past profits.* Similarly, if a current expenditure arises from a transaction that produced a profit in a prior year of assessment, the expense may be deductible under s 16(1). For example, in *Texas Company (Australasia) Ltd v FCT* (1940) 63 CLR 382, the taxpayer incurred an expense in the current year when it paid a foreign currency-denominated debt that it had incurred (and deducted) in a prior year when the exchange rate was more favourable. The goods acquired in the transaction giving rise to the debt had been sold at a profit in the prior year. The court allowed the deduction of the foreign-currency expense in calculating the current year's profits.
7. *Cessation of business.* In *Overseas Textiles Ltd v CIR* (1987) 3 HKTC 29, the taxpayer decided to cease its textile manufacturing business, demolish its factory, and commence dealing in property. In so doing, the taxpayer breached certain contracts under which it was obliged to supply goods. It paid compensation for the breaches of contract, and claimed that the compensation payments were deductible in calculating its profits. The court denied the deduction on the ground that the payments were not incurred in the production of profits. Rather, said the court, the payments were made for the purpose of terminating the textile business. Would the result have been different if the taxpayer's representative had stressed the fact

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Departmental Interpretation and Practice Notes No 10. The following excerpt is taken from the June 2007 version, which also takes into account the decision in *Lee Hung-kwong*. Editorial comments in italics and square brackets have been inserted by the authors.

1. Departmental Interpretation and Practice Notes No 10: The Charge to Salaries Tax

a. *Basic charge – employment*

Introduction

1. The basic charge to Salaries Tax is imposed by s 8(1) of the Inland Revenue Ordinance ('the Ordinance') on income 'arising in or derived from Hong Kong' from any office or employment of profit. No general rules are given in the Ordinance for determining whether income 'arises in or is derived from Hong Kong'. However, in deciding this question in connection with employment, it has long been accepted that it is necessary to establish the place where the employment, the source of income, is located.

[*As noted earlier, contrary to the IRD's assertion, the place-of-employment test has been questioned by a number of Hong Kong tax scholars over the years. See the articles cited in Note 1 following the excerpt from the Goepfert decision, above.*]

2. DIPN 10 was first issued in January 1982 and revised in December 1987 after the High Court decision in *Goepfert*'s case. In the 1987 version of DIPN 10, the Department has accepted that in the great majority of cases, the question of Hong Kong or non-Hong Kong employment can be resolved by considering three factors, namely, (a) contract of employment, (b) residence of the employer, and (c) place of payment of remuneration.
3. Since the issue of the 1987 revision of DIPN 10, the Board of Review had heard over 30 cases on the source of employment. While most Boards had taken into account the above-mentioned three factors in their decision, some Boards had expressed the view that the 1987 revision was inaccurate and misleading and the three-factor test promulgated in the Notes was contrary to the 'totality of facts' test set out by MacDougall J in the *Goepfert* decision. There is indeed a need to bring the 1987 version up-to-date.

[*For examples of particularly strong criticism of the three-factor test promulgated in the 1987 version of the DIPN, see D 40/90 (1990) 5 IRBRD 306, 314, D 87/00 (2000) 15 IRBRD 750, 764 and D 125/02 (2003) 18 IRBRD 179, 185 where the Board stated: 'There is no justification for the three tests as promulgated by the Commissioner in the Practice Note. It is contrary to the totality of facts test set out in (Goepfert's case).'*]

4. In this present revision, the Department does not seek to introduce a new approach in determining the source of employment. The Department still holds the view that the above-mentioned factors are the major factors in determining source of employment. This revision intends to set out in clearer terms the Department's practices in determining the source of employment.

[*The IRD's repeated references to 'determining the source of employment' rather than determining the source of income from employment, which is what the statute refers to, indicates the extent to which the place-of-employment analysis adopted in the Goepfert decision has come to dominate the thinking of the IRD on this issue.*]

The Goepfert decision

...

6. The Department accepts the learned judge's view [*in the Goepfert* case] and would follow [his] approach. No doubt, the contract of employment is the key factor in ascertaining the location of the employment. In the course of examination, the Department may need to look further than the external or superficial features of the employment. In determining where the source of income, the employment, is located, the Department will take into account all of the relevant facts, with particular emphasis on:
   (a) where the contract of employment was negotiated and entered into, and is enforceable, whether in Hong Kong or outside Hong Kong;
   (b) where the employer is resident, whether in Hong Kong or outside Hong Kong; and
   (c) where the employee's remuneration is paid to him, whether in Hong Kong or outside Hong Kong.

Source is a practical hard matter of fact. The Department's practice is set out below.

Contract of employment

Written contract

7. The contract to be considered is that which is currently in force and which is the basis for the relationship of master and servant existing between the employer and employee. ...

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Parties to the contract

9. While the Department would generally accept the parties named in the contract as the relevant parties, the Department would take steps to verify the genuineness of the relationship between the parties if warranted by circumstances. For example, if a company in its capacity as an employer, sponsors an individual to gain entry into Hong Kong to take up employment and has represented to other Government departments to that effect, this will be a factor for the Department to take into account together with other relevant facts in determining whether an employer-employee relationship exists between the sponsor and the individual.
10. In testing whether a true employer-employee relationship exists between the parties, the Department would also consider who has the legal liability to pay or control over the employee, the capacity in which the employee represents himself to third parties, whether the employee is part of the organisation of the employer, etc.

Contract negotiated and concluded

11. It would be up to the taxpayer to provide the full facts as to where and when the negotiation took place, the persons taking part in the negotiation, the matters discussed, the terms agreed, etc. If a written contract was subsequently executed, a copy of the contract needs to be provided.
12. If the employer is resident in Hong Kong, it is unlikely that a claim for non-Hong Kong employment will be accepted even if it is shown that negotiation takes place outside Hong Kong or a contract of employment is signed outside Hong Kong. The following Board of Review Decision serves to illustrate the point: *D 8/92* 7 IRBRD 107 ...

Enforceability of contract

13. In a contract of employment, the parties are free to choose the governing law so far as it is bona fide, legal, not against public policy, and unambiguous. Where there is no express choice of law, the choice of law can be inferred from the terms of the contract and the general circumstances of the case. Where there is no express or implied choice of law, the contract is governed by the system of law with which the contract has its closest and most real connection (*Bank of India v Gobindram Naraindas Sadhwant* [1988] 2 HKLR 262).
14. From the above guideline, in determining where an employment contract is enforceable, it is necessary in certain circumstances to ascertain where the employee habitually performs his work, the business that engaged him and where that business is located. It may also be necessary to consider the place where the parties would take legal action in enforcing terms of the contract from a practical perspective, see eg, *D 20/97* 12 IRBRD 161, 172 and *D 59/03* 18 IRBRD 626, 651.

Residence of employer

15. The employer for this purpose is the person who, in the relationship of master and servant, is the true employer of the employee.

Central management and control

16. In determining the residence of a corporation, the Department will take into account where the corporation's central management and control is located. The 'central management and control' test is a well-established common law principle widely adopted in many jurisdictions for determining residence of companies. Under this principle, a company resides where its real business is carried on, and the real business is carried on where the central management and control actually abides. ....
17. In *Charter View Holdings (BVI) Ltd v Corona Investments Ltd & Another* [1998] 1 HKLRD 469, the issue of whether the plaintiff was ordinarily resident in Hong Kong was before Keith J, who made the following comments at p 471:

> In *Insurance Co of the State of Pennsylvania v Grand Union Insurance Co Ltd* [1988] 2 HKLR 541, the Court of Appeal held that, for the purpose of O 23, r 1(1)(a) [Rules of the High Court], the ordinary residence of a limited company is to be decided by reference to where its central management and control is. However, the application of that test is not straightforward. It was considered in *Re Little Olympian Each Ways Ltd* [1995] 1 WLR 560. Three propositions can be derived from the judgment of Lindsay J:
>
> (i) The mere assertion of where the company's central management and control is unsatisfactory. What are needed are the primary facts on which that assertion is based.
>
> (ii) All the circumstances in which the company carries on its business should be taken into account, though the weight to be applied to each factor will obviously differ from case to case. Those factors include the provisions of the company's objects clause, the place of incorporation, the place where the company's real trade and business is carried on, the place where the company's books are kept, the place where the company's administration is carried out, the place where the directors with power to disapprove of local steps or to require different ones to be taken themselves meet or are resident, the place where its chief office is or where the company secretary is to be found, and the place where most significant assets are.

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(iii) In applying the test to a non-trading company, it may be more important than would otherwise be the case to have regard to the nature of the company's corporate activities.

18. The issue of whether a company was centrally managed and controlled outside Hong Kong or in Hong Kong was critically examined in *D 123/02* 18 IRBRD 150. The Department will follow the above guiding principles in ascertaining where a limited company resides. In general, importance is attached to the place where the directors hold board meetings. In many cases, the directors meet in the country where the business operations take place, and central management and control is clearly located in that place. In other cases, the directors may exercise central management and control in one jurisdiction, while the actual business operations may take place in another. The place of board meetings, however, is significant only in so far as those meetings constitute the medium through which central management and control is exercised. The location where central management and control is exercised is a question of fact and each case must be decided on its own facts. When reaching a conclusion in accordance with case law principles, only factors which exist for genuine commercial reasons will be accepted.

[*Notwithstanding the above, the IRD has sometimes asserted that an employer is resident in Hong Kong even though central management and control was overseas. In D 79/97 (1997) 12 IRBRD 461, the Board of Review found that the employment was located in Hong Kong in a case where the employer was centrally managed and controlled overseas but had a branch registered in Hong Kong; the taxpayer's salary was paid outside Hong Kong; and the employment duties were regional in nature.*]

Parent and subsidiary

19. In applying the 'central management and control' test in the situation of a subsidiary company and its parent operating in another territory, the Department would normally regard the subsidiary and its parent as separate legal entities, each being managed and controlled by its own board of directors. While it is normal for a parent company to exert influence and exercise power over the subsidiary company, it is not always the case that the subsidiary is resident in the same territory as the parent. Regard will be given to the degree of autonomy with which the board of directors in the subsidiary deals with such matters as to investment, production, marketing and procurement without reference to the parent. In this regard, the Department is mindful of the comments in *D 59/03* 18 IRBRD 626, 653:

> Even if Company A's final and supreme authority were to come from its parent company, Company D in the United States of America, we do not accept the Representative's assertion that Company A was centrally managed and controlled by its parent company in the United States of America. In arriving at this stance we are mindful of the *Union Corporation* case (1953) 34 TC 207 where it was held the formula 'where the central power and authority abides' does not demand that the court should look, and look only, to the place where the final and supreme authority is found, and also the decision in the *De Beers* case (1906) 5 TC 198 that what was required was 'a scrutiny of the course of business and trading'. Thus, we find Company A was resident in Hong Kong for the purpose of this tax assessment.
>
> ...

Place of payment of remuneration

21. In *D 20/97* 12 IRBRD 161, the Board had the following observation at p 173:

> ... it would seem to be absurdly simple and inappropriate in this age of electronic banking to reach our decision on the basis that the place of payment determined the source of employment income in this case. Surely source of employment, which should be determined as a 'practical hard matter of fact', should not depend in the final analysis upon the place from where an employee is actually paid. Accordingly, we decided to look more broadly, from a practical perspective, at where the Taxpayer's employment was located.

....

23. The Department will readily follow the above approach. Payment of the remuneration made outside Hong Kong, when viewed on its own, should not be a determinative factor in ascertaining the source of employment. ...

[*In D 39/10 25 IRBRD 776, the Board ruled that the employment was located in Hong Kong where the employer was a Hong Kong company notwithstanding that (1) the employment contract was entered outside Hong Kong, (2) the taxpayer was assigned to work in the PRC branch of the employer, and (3) the taxpayer's salary was paid to his bank account in the PRC.*]

Look further than the external or superficial features

24. If a person claims that his employment with an employer resident in Hong Kong has been changed to a related company of the employer, which is resident outside Hong Kong, and there is little apparent change in the terms of employment, the Department will look deeper than the external or superficial features of the employment. Similarly, attention will be given to cases where locally-engaged employees claim that they hold offshore contracts of employment. These examples are not meant to be exhaustive.

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