

P. C.
G.M.B. 2

Judgment
19, 1966

IN THE PRIVY COUNCIL

No. 42 of 1964

ON APPEAL

FROM THE SUPREME COURT OF HONG KONG

(Appellate Jurisdiction)

B E T W E E N:

COMMISSIONER OF INLAND REVENUE Appellant

- and -

MUTUAL INVESTMENT COMPANY LIMITED Respondent

C A S E FOR THE RESPONDENT

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Record

1. This is an appeal from a Judgment and Order of the Supreme Court of Hong Kong (Appellate Jurisdiction) (Hogan C.J. (President) and Rigby J.) dated January 25th, 1964, allowing an appeal by the Respondent against a decision of Huggins J. dated October 4th, 1963. pp. 35-36

By his said decision Huggins J. had so far as is material to this present Appeal dismissed an appeal of the Appellant against a decision of the Board of Review annulling in part assessments determined by the Appellant Commissioner of Inland Revenue on the profits of the Respondent Company for the years of assessment 1960/1 and 1961/2. pp. 12 - 32

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2. The matter arises in the following way. The Respondent Company was incorporated in Hong Kong on 23rd November, 1956. Its registered office is at 604, Edinburgh House, Hong Kong. It commenced business the same day and acquired investments in the form of shares in the following companies : pp. 2 & 3

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- 1. Lee Hysan Estate Co.Ltd. \$370,000
- 2. Spa Food (F.E.) Ltd. 233,000

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2.

<u>Record</u>	3. General Bottling Co. Ltd.	132,000
	4. International Beverages Co. Ltd.	115,000
		<u>247,000</u>
		<u>8850,000</u>

Until the year ended 31st March, 1959 the Respondent Company's only income was by way of dividend and a small amount of bank interest. For the years of assessment 1956/57 to 1959/60 the Respondent Company was assessed as being under no liability to tax. During the year ended 31st March 1960, the Respondent Company borrowed money which it in turn lent out at interest to another company. There have been no other activities entered into by the Respondent Company and there have been no additions to or changes in the share investments. During the years ended 31st March, 1960 and 1961 the Respondent Company received income from dividends and interest and incurred expenditure as shown in the Stated Case. In accordance with Section 26(a) of the Inland Revenue Ordinance the dividend profits were excluded from the assessable profits for the purpose of assessing the profits liable to tax for the years 1960/61 and 1961/62. After adding back the items of expenditure which he considered not allowable as deductions for tax purposes, the Assessor apportioned the balance of the expenses, in the proportion of the non-assessable income (i.e. the dividends) to the total income and disallowed the sum so calculated as being expenses applicable to the production of non-assessable income.

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3. The main relevant statutory provisions are set out in the following extract from the Inland Revenue Ordinance Chapter 112:

"Section 2 (1) "Assessable profits"
means the net profits for the basis period arising in or derived from the Colony calculated in accordance with the provisions of Part IV but

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does not include profit arising from
the sale of capital assets;"

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10 "Profits arising in or
derived from the Colony" for the
purposes of Part IV shall without
in any way limiting its meaning of
the term include all profits from
business transacted in the Colony
whether directly or through an
agent".

20 "Section 14 (1) Corporation profits
tax shall, subject to the provis-
ions of this Ordinance, be charged
for each year of assessment on
every corporation carrying on
trade or business in the Colony
in respect of the profits of the
corporation arising in or
derived from the Colony from such
trade or business.

(2) Any sum arising in or
derived from the Colony other than
a sum from the sale of capital
assets, received by or credited to
a corporation carrying on a trade
or business in the Colony shall be
deemed to arise from the trade or
business carried on".

30 "Section 16 (1) For the purpose of
ascertaining the assessable profits
of any person there shall be
deducted all outgoings and expenses
wholly and exclusively incurred
during the basis period for the
year of assessment by such person
in the production of profits in
respect of which he is chargeable
to tax under this Part".

40 "Section 17 (1) For the purpose of
ascertaining profits in respect
of which a person is chargeable to
tax under this Part no deduction
shall be allowed in respect of -

(b) any disbursements or expenses

4.

Record

not being money expended
for the purpose of
producing such profits;"

"Section 26 For the purpose of assess-
ment under this Part -

(a) a dividend from a corporation
which is chargeable to tax under
this Part shall not be included
in the assessable profits of any
other person,"

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"Section 51 (1) An assessor may give
notice in writing to any person
requiring him within a reasonable
time stated in such notice to
furnish a return of any sum assess-
able to property tax, salaries and
annuities tax, profits tax and
interest tax under Parts II, III,
IV and V, containing such
particulars and in such form as
may be prescribed".

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4. The Respondent Company appealed to the
Appellant under Section 64 of the Inland
Revenue Ordinance, being a person
aggrieved by an assessment. At that appeal
the Assessor, having reconsidered the
apportionment of the expenses, was prepared
to amend the assessments to allow the whole
of the interest paid as a direct charge
against the interest received, and to treat
an amount of £100 paid as a gratuity to an
employee among the balance of apportionable
expenses.

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5. The Respondent Company appealed against
the decision of the Appellant to the Board of
Review under Section 66 of the Inland Revenue
Ordinance. The Board of Review annulled the
assessment so far as it disallowed expenditure
which the Assessor had apportioned to the
Respondent Company's non-assessable income.

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6. The Appellant appealed against the
decision of the Board of Review. The appeal
by the Appellant was heard by the Supreme

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- Court of Hong Kong (Original Jurisdiction) (Huggins J.) on 15th and 16th July 1963, and judgment was delivered by the said Court on 4th October, 1963. The Court held so far as is relevant to the present appeal that the part of the decision of the Board which annulled the assessment was not right and that the expenses in question were not allowable.
- Record
- pp. 12-32
p. 32
- 10 7. At the hearing before Huggins, J. the Appellant argued that Section 26(a) of the Ordinance operated to exclude from the profits which by Section 14(1) were chargeable to tax those dividends received from other corporations which were themselves chargeable to tax; that Section 17(1)(b) expressly disallowed "for the purpose of ascertaining profits in respect of which a person is chargeable to tax" deduction of
- 20 "any disbursements or expenses not being money expended for the purpose of producing such profits". This argument involved construing the phrases "profits chargeable to tax" and "assessable profits" as synonymous save for the qualification that profits chargeable to tax might not all be assessable profits because part of the profits chargeable might not have been received in the basis period.
- 30 Counsel for the Appellant submitted that there was no ambiguity in those provisions. He argued that the intention of the legislature was clear and could be ascertained from the history of the provisions. Section 16(1) was amended in 1955 and the words "assessable profits" defined, and Section 18A was added to provide that tax should "be charged for each year of assessment on the assessable profits".
- 40 In 1956 Section 16 was further amended. The only purpose of the 1956 amendment was to allow the deduction of expenses incurred during the basis period in producing profits made outside the basis period and therefore assessable in another year.
- p. 21
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- p. 23
- Counsel for the Respondent Company contended that the purpose of the 1956

<u>Record</u> Cap. 112	amendment was to remove a manifest absurdity; that before that amendment Section 16(1) provided that one should deduct the outgoings and expenses incurred in the production of assessable profits - which in the premises had not yet been ascertained - in order to ascertain those same assessable profits. Reference was made to the speech of Lord Dunedin in <u>Whitney v. Commissioners of Inland Revenue</u> (1926) A.C. 37 at page 52.	10
pp. 24-25 Cap. 112	The learned Judge observed that it was agreed that Section 14 determined the persons liable and the property in respect of which they were so liable to tax - the first stage. The second stage of imposing the assessment was, according to the Company, provided for by Sections 16, 17 and 26; these made clear what should and should not be deducted in reaching the "assessable profits"; this involved construing "subject to the provisions of this Ordinance" in Section 14(1) as referring to Sections 16 or 17 but not to Section 26. Section 26 was designed to prevent double taxation; it provided for a further deduction from the profits chargeable to tax in order to arrive at the assessable profits; that Section said that dividends should not be included in the assessable profits. The Respondent	20
Cap. 112	Company sought further support for their argument from the form of Return prescribed under Section 51. The Respondent Company also argued that to construe the phrase "profits in respect of which he is chargeable to tax" in Section 16(1) as meaning "Adjusted Profits" (a phrase used in the prescribed form of return and taken by the Respondent to mean "assessable profits") would be inconsistent with Sections 19(1) and 59.	30
p. 25	While the Board pointed out that the Crown, having contended that Section 26 dividends were not profits chargeable to tax, relied on Section 17(1)(b) as expressing the legislature's intention to disallow the expenses incurred in earning the dividends, the Board had questioned	40
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where provision was made for such dis-
allowance to be calculated precisely or
even on an equitable basis; it considered
that apportionment was arbitrary and
inequitable. The Crown submitted that
apportionment was the proper and usual method
of dealing with such cases citing London &
Northern Estates Co.Ltd. v. Harris 21 Tax
Cases 197 and the Royal Commission on
Taxation of Profits 1955. Counsel for the
Respondent Company relied on Hughes v. Bank
of New Zealand 21 Tax Cases 472 as authority
for the proposition that because there is no
express provision for apportionment no such
apportionment can be made and cited passages
from the judgments of Lord Wright, M.R. at
page 506 and Lawrence, J. at page 486. The
The Learned Judge observed that the Act in
question was not in terms identical with
the Ordinance with no equivalent to Section
16(1) of the Ordinance; accordingly that
case did not advance the Respondent Company's
argument.

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The learned Judge rejected that
argument and concluded that the considera-
tions of accounting practice and the absence
of any express provision for apportionment
did not favour the construction contended
for by the Respondent Company any more than
that contended for by the Crown. The taxpay-
er, in such cases, could always endeavour to
give the assessor such information as
would make apportionment unnecessary - or at
least give a basis for a reasonably accurate
apportionment.

p. 29

Those remarks also disposed of the
further argument that, even if apportionment
were permissible, then upon the Appellant's
construction of the statute the subject
would not be compelled by Section 51 to make
a return of dividends covered by Section
26(a) at all and the assessor would not
have the material upon which he could make
an apportionment.

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He considered that there would be
no inconsistency with other provisions in
the Ordinance if Section 16(1) were

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<u>Record</u>	construed in the sense contended for	
Cap. 112	by the Appellant: the Respondent Company's	
Cap. 112	submission based on Section 19 overlooked	
	the reference in that Section to Section 70,	
	while the Appellant's interpretation of the	
	phrase "profits chargeable to tax" would	
	not compel an interpretation of the phrase	
	"person chargeable to tax" in Section	
Cap. 112	59 which would be in any way strange or	10
	absurd.	
	The learned Judge concluded that he	
p. 31	had no compelling guide to the Ordinance,	
	but had reached a conclusion contrary to	
	that of the Board. The Crown was not	
	seeking to impose double taxation in respect	
	of the dividends. It seemed to him that	
Cap. 112	looking fairly at the language of Section	
Cap. 112	51, the phrase "subject to the provisions	
	of this Ordinance" in Section 14(1), the	20
Cap. 112	words "shall not be included" in Section	
Cap. 112	26(a) and the express reference to profits	
	chargeable to tax in Section 16(1) and	
	Section 17(1), the Ordinance did provide a	
	warrant for the disallowance of the	
	expenses in question. He accordingly	
p. 32	allowed the appeal as to that part.	
p. 33	8. The Respondent Company appealed from	
	the decision of Huggins, J. The Appeal was	
	heard by the Full Court of the Supreme	
	Court of Hong Kong (Appellate Jurisdiction)	30
	(Hogan C.J. and Rigby J.) on 27th, 28th and	
pp. 35-36	29th November, 1963 and on the 25th January,	
	1964 the Court delivered judgment allowing	
	the Respondent Company's appeal.	
	9. The judgment of the Full Court is	
	summarised as follows:	
pp. 44 & 45	It was contended for the Respondent	
Cap. 112	Company that Section 14 of the Inland	
Cap. 112	Revenue Ordinance which fixed the liability	40
	to tax charged to tax all the profits of	
	the corporation; that Section 16(1)	
	required that expenses wholly and exclus-	
	ively incurred during the basis period in	
	the production of profits chargeable to	
	tax be deducted and that, after such	
Cap. 112	deduction had been made, Section 26 applied	

to exclude from assessable profits dividends on which tax had already been paid. Section 16 correctly interpreted, prescribed that the expenses incurred were to be deducted from the profits chargeable to tax or the "gross profits" and that what remained after that deduction, i.e. the assessable profits, could not be the same as the subject matter from which the deduction was made.

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10 For the Appellant it was contended that assessable profits and profits chargeable to tax were, in effect, the same thing; that profits could only be ascertained when all outgoings had been deducted and that consequently, Section 14(1) only charged what remained after the permissible outgoings had been deducted; that that result was clearly implied and emphasised by the words "subject to the provisions of this Ordinance" before the words "be charged" in

20 Section 14(1). That contention obtained support from the speech of Lord Herschell in Russel v. Aberdeen Town and County Bank 2 Tax Cases 321, at page 327, and was reinforced by observations in Vulcan Motor and Engineering Company (1906) Limited v. Hampson (1921) 3 K.B. 597 per Bankes L.J. at page 601 and per Scrutton L.J. at page 605.

pp. 45 & 46

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30 The Court observed that the Hong Kong Ordinance had, by an amendment in 1935, introduced the expression "net profits", which expression, contrasted with profits, detracted from the Appellant's argument that profits mentioned in Section 14 as being chargeable were the "end product" and consequently the same thing as net profits.

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40 Section 16 declared that "for the purpose of ascertaining assessable profits" such outgoings and expenses as were wholly and exclusively incurred . . . in the production of profits in respect of which he (the taxpayer) is chargeable to tax" should be deducted; it appeared to the Court that the legislature was using the expression "profits in respect of which he is chargeable to tax" to indicate something

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<u>Record</u>	different from assessable profits, otherwise the reference at that point would have been not to profits chargeable to tax, but simply to "such profits", or to "assessable profits", either of which terms would have limited the outgoings and expenses to those incurred in the production of the assessable profits.	
pp.48 & 49	In contending that the effect of the difference between the expressions should be limited, Counsel for the Appellant referred to the relevant portion of Section 16 prior to 1935, the amendments to that Section, the insertion of the definition of "assessable profits" and the amendment to the definition of "basis period", all made in 1955, and the alteration of Section 16 and the definition of "basis period" both made in 1956. It was argued that, after the 1955 amendment and prior to the 1956 amendment, only the expenses incurred in producing the assessable profits could be deducted, the effect of the 1956 amendment was not to authorise the deduction of expenses incurred in the production of profits, which would not, at some time, become assessable profits, but merely to authorise the deduction of expenditure incurred for the purpose of producing assessable profits in a different period; that the deductible expenditure was still limited to that incurred for the purpose of producing profits which would, in some years, be assessable. In support of this construction attention was drawn to a passage from the judgment of Lawrence, J. in <u>Hughes v. Bank of New Zealand</u> , 21 Tax Cases 472 at page 506 and Lord Thankerton at page 524.	10
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pp.49 & 50		20
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p. 51	For the Respondent Company it was argued that the passage from the judgment of Lawrence J. (page 486) was distinguishable for the reason that Lawrence, J. had in mind securities which were entirely exempt from tax whereas the present case was concerned not with dividends which were, per se, exempt from tax, but which were, by virtue of Section 26, excluded from the final figure of assessable profits.	40

10 The Court considered that this argument gave too little weight to the terms of the provisions which conferred exemption on the stocks and securities in Hughes's case. In that case Section 46 of the Income Tax Act, 1918 and rule 2(d) of Schedule C had been relied on. The Court doubted if Lawrence J. would have seen in the language of exemption any distinction sufficient to remove the present case from the scope of his statement, What Lawrence J. had said in that respect was obiter: his decision had been that the argument of the Crown could not be sustained on the basis of the English rule which gave a wider field of deduction than would have been conferred by the expression "profits brought into charge".

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pp. 51 & 52

8 & 9 Geo.5
c.40

20 The Court observed that the language used for the purpose of imposing a liability and establishing the Crown's right to recover was not identical in the Hong Kong Ordinance with that used in the English Income Tax Acts. (Sections 71, 75(1), 76(1) and 77(1) of the Hong Kong Ordinance and Sections 169(1), 68
30 Miscellaneous Rules 4, 5 and 7 of Schedule D and Section 123(3) of the Income Tax Act, 1918 were referred to). In consequence it would appear quite possible that, in England, a judicial reference might be made to "profits brought into charge" in circumstances where, in Hong Kong, the reference would be to "assessable profits"; a reference to "chargeable profits" under the English Act could include what in Hong Kong would be either chargeable or assessable profits. Lawrence J. had not
40 been concerned with the distinction which the Respondent Company sought to make between "chargeable" and "assessable" profits.

p. 52 - 54

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8 & 9 Geo.5
c.40

Counsel for the Appellant had also placed much weight on the presence of the words "subject to the provision of this Ordinance" before the words "be charged" in Section 14(1). The Court said that those words governed the operation of the

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charge and if, at some point elsewhere in the Ordinance, there had been a clear indication that the expenses attaching to those dividends were to be excluded from the charge, the Court would have accepted the contention, but they did not think that the exclusion of the dividend from assessment could have that effect when the Ordinance had drawn a distinction between charging and assessing.

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The Court considered that the absence of any specific provision for apportionment of expenses such as those in question did little to help either side.

pp.55 & 56

The Court summarised their conclusions by saying that those dividends were part of the profits of the company and would only be excluded by the operation of some statutory provisions; that under the provisions of the Ordinance they were to be excluded from the assessable profits and there was nothing to say that they were to be excluded from the chargeable profits; that the Ordinance indicated that chargeable profits and assessable profits were not the same thing and the terms of the Ordinance did not seem to show that the only distinction between them was that assessable profits were limited by prescribed terminal points: indeed if the only difference between chargeable and assessable profits was the period within which they were made, then one would have expected to have found, in the definition of assessable profits, the expression "chargeable profits" or its equivalent where, in fact, "net profits" appeared.

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10. The proceedings involved another question as to allowance for depreciation claimed in respect of a motor car belonging to the Respondent Company. That question came before the Full Court by way of cross-appeal from the decision of Huggins J. Although the decision of the Full Court was not wholly favourable to the Appellant, it is not here under appeal.

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11. The Appellant applied to the Full Court of the Supreme Court of Hong Kong (Rigby Ag. C.J. and Blair-Kerr J.) on the 15th February, 1964, for leave to appeal to Her Majesty in Council from the judgment of the Supreme Court upholding the appeal of the Respondent Company from the judgment of Huggins J. On February 22nd, 1964, the Full Court dismissed the Appellant's application for leave to appeal as the time limit for making such an application, laid down by Rule 3 of the Hong Kong (Appeals to the Privy Council) Order in Council, 1909 had expired. An Order was made accordingly.
12. The Appellant petitioned Her Majesty in Council and an Order granting special leave to appeal to Her Majesty in Council was made on July 3rd, 1964.
13. The Respondent respectfully adopts the conclusion reached by the Supreme Court (Appellate Jurisdiction). The assessable profits can only be what is left after the deduction of the expenses - all the expenses - referred to in Section 16(1) and it is from those assessable profits thus ascertained that the dividend income is to be excluded under Section 26(a). The terms of Section 26(a) provide no warrant for giving Section 16(1) anything other than its full effect.
- If the legislature had intended to restrict the deduction of expenditure by reference to dividend income it would no doubt have inserted a provision comparable to what is now Section 436(2) of the United Kingdom Income Tax Act, 1952 (whose forerunner, Section 21(2) of the Finance Act, 1940, was introduced after the decision in Hughes v. Bank of New Zealand Limited (1938) A.C. 366). But it did not do so, and the omission is perhaps not surprising. The Bank of New Zealand case and Section 436(2) were of course concerned with income which was wholly exempt from tax, and not with dividend income representing profits which have already been fully taxed. It may be of some interest to note that under the United

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15 & 16 Geo,
6 & 1 Eliz.2
c.10;
3 & 4 Geo.6
c.29

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1 Edw.8 &
1 Geo.6
c.54

Kingdom profits tax legislation dividend income is excluded from the chargeable profits in terms resembling those of Section 26(a) (see para. 7, Fourth Schedule, Finance Act, 1937, as amended) without any corresponding restriction of deductible expenditure.

14. Accordingly the Respondent humbly submits that the decision of the Supreme Court of Hong Kong (Appellate Jurisdiction) was correct and should be affirmed for the following among other 10

R E A S O N S

Cap 112 (1) THAT the words "profits chargeable to tax" in Section 14(1), the charging section, plainly include dividends, and, in determining the assessable profits, Section 16(1) authorises deduction of expenses and outgoings wholly and exclusively incurred in the production of such chargeable profits in computing the assessable profits. 20

Cap 112 (2) THAT the Supreme Court of Hong Kong (Appellate Jurisdiction) was correct in concluding that the word "profits" in Section 14 had a wider meaning than "assessable profits" and in distinguishing assessable profits and profits chargeable to tax in Section 16. 30

Cap 112 (3) THAT the effect of the amendments to Section 16(1) in 1956 is to make it clear that the words "assessable profits" cannot have the same meaning as "profits ... chargeable to tax" in the latter half of that subsection.

15 & 16
Geo.6 and
1 Eliz.2
c.10 (4) THAT there is no provision in the Ordinance comparable with Section 436(2) of the Income Tax Act, 1952 and the absence of any such provision, in the light of Hughes v. Bank of New Zealand supports the Respondent's submission. 40

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(5) THAT the judgment of the Supreme Court
of Hong Kong (Appellate Jurisdiction)
was correct and should be upheld.

Record

MICHAEL NOLAN.

No. 42 of 1964

IN THE PRIVY COUNCIL

ON APPEAL

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KONG

(APPELLATE JURISDICTION)

BETWEEN:

COMMISSIONER OF INLAND REVENUE

v.

MUTUAL INVESTMENT COMPANY LIMITED

C A S E

FOR THE RESPONDENT

MARKBY STEWART & WADESONS,
Moor House, London Wall,
LONDON, E.C.2.

Solicitors for the Respondent.