

Privy Council Appeal No. 42 of 1964

Commissioner of Inland Revenue - - - - *Appellant*

v.

Mutual Investment Company Limited - - - - *Respondent*

FROM

THE SUPREME COURT OF HONG KONG

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF
THE PRIVY COUNCIL, DELIVERED THE 20TH JULY, 1966

Present at the Hearing:

LORD PEARCE

LORD WILBERFORCE

SIR GARFIELD BARWICK

[*Delivered by SIR GARFIELD BARWICK*]

This appeal from a judgment of the Full Court of the Supreme Court of Hong Kong involves the construction of certain provisions of the Inland Revenue Ordinance Cap. 112 as amended to 1956 of the Colony of Hong Kong (the Ordinance). The dispute between the parties is as to the deductibility in the computation of profits tax for the tax years 1960/61 and 1961/62 of certain expenses of the respondent which may be briefly described as expenses incurred in the production of dividends in respect of the receipt of which the respondent is not liable to pay profits tax under the Ordinance. The tax assessor disallowed the respondent's claim to deduct such expenses in computing the amount of the respondent's profits upon which it was assessable to tax, and made his assessment of the profits tax payable by the respondent in respect of the said tax years accordingly. No question is raised in this appeal as to the method actually employed by the assessor in arriving at the amount of such expenses, nor is the amount of such expenses now in dispute.

The respondent pursuant to section 64 of the Ordinance appealed to the Commissioner of Inland Revenue, the present appellant, against the assessor's disallowance of such expenses and also of certain other items. This appeal is concerned only with the disallowance of the expenses, the respondent either being now satisfied with the decisions which have so far been taken with respect to the other items or having decided not to appeal against any such decision.

The appellant confirmed the assessor's disallowance of the expenses. The respondent then appealed to a Board of Review constituted under the Ordinance. Sections 65 and 66 of the Ordinance. The Board of Review reversed the assessor's disallowance and annulled so much of the assessments as disallowed the expenses. The appellant, pursuant to section 69 of the Ordinance, required the Board of Review to state a case for the opinion of the Supreme Court. The Board did so. The question submitted was, in substance, whether the Board was right in annulling that part of the assessment which disallowed the expenses. The stated case was heard by the Supreme Court in its original jurisdiction. The learned judge who constituted the Supreme Court for this purpose decided that the Board of Review was in error and that the expenses were not deductible. Accordingly, he answered the question in the stated case in the negative. Upon an appeal by the respondent to the Full Court of the Supreme Court against that decision the Full Court reversed it and answered the question in the affirmative, thus supporting the decision of the Board of Review.

As the question for their Lordships is purely one of construction of the relevant sections of the Ordinance, it will be convenient, before detailing the particular circumstances of the case, to set out those sections.

The Ordinance provides for the imposition, assessment and collection of taxes on earnings and profits. It devotes a part to each particular tax. Part IV deals with Profits Tax with which this appeal is concerned. The following are the presently significant provisions of this part:

“ 14. (1) Corporation profits tax shall, subject to the provisions 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.”

“ 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, including—” a list of specific items, concluding with,

“(h) such other deductions as may be prescribed by any rule made under this Ordinance.”

“ 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—” a list of specific expenditure, including

“(b) any disbursements or expenses not being money expended for the purpose of producing such profits;”

“ 18A. Corporation profits tax shall be charged for each year of assessment at the standard rate on the assessable profits of a corporation for that year ascertained in accordance with the provisions of this Part.”

“ 26 (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.”

“ Assessable profits ” are defined by section 2 of the Ordinance to mean “ the net profits for the basis period arising in or derived from the Colony calculated in accordance with the provisions of Part IV but does not include profits arising from the sale of capital assets ” and “ profits arising in or derived from the Colony ” is said “ for the purposes of Part IV, . . . without in any way limiting the meaning of the term, to ‘ include all profits from business transacted in the Colony, whether directly or through an agent ’ ”;

The “ basis period ” for any year of assessment is the period on the income or the profits of which tax for that year ultimately falls to be computed;

The “ year of assessment ” is the period of twelve months commencing on 1st April in any year.

The respondent was incorporated in Hong Kong in 1956 and thereafter carried on business exclusively in that Colony. Until the end of the first quarter of 1959, its only income consisted in dividends upon shares held in other companies and a small amount of bank interest. It is common ground that these other companies were, at all relevant times, “ chargeable to tax ” under Part IV of the Ordinance. The dividends from them thus fell within the provisions of section 26 (a) of the Ordinance. Consequently in the tax years up to but not including the tax year 1960/61 the respondent produced no profits in respect of which it was taxable under Part IV of the Ordinance.

However, during the year which ended on the 31st March 1960, which is the basis year for the tax year 1960/61, the respondent borrowed money which it lent out at interest to another company. The expenses of running its business were evidently increased by reason of this added activity, which produced profits in respect of which, as is common ground, the

respondent is liable to be taxed under Part IV. The same conditions obtained in the basis year for the tax year 1961/62.

The sole question in the appeal is whether the whole of the expenses of the respondent incurred in the production of its profits in the basis years is deductible when computing the amount upon which profits tax is to be assessed, or whether only so much of those expenses as is referable to the production of the respondent's receipts from the lending of money is deductible.

Although some arguments were addressed to their Lordships as to the justice and equity or otherwise of the disallowance of the expenses in question, no such matter really arises. What is to be decided is the true meaning of the various provisions of the Ordinance, not expressed with any notable clarity. The respondent is entitled to whatever benefit it can derive from their true construction just as much as he must bear whatever consequences flow from it. No doubt in cases of ambiguity, that construction which the better serves the ends of fairness and justice will be adopted, but otherwise it is for the legislature in forming its policy to consider such elements.

The Full Court reached its conclusion that all the expenses of the respondent were deductible by discerning a distinction drawn by the Ordinance between assessable profits and "chargeable" profits and by regarding "chargeable" profits as those profits in respect of which the taxpayer was chargeable to tax within the meaning of sections 16(1) and 17(1) of the Ordinance. The Full Court held that section 14(1) of the Ordinance brought to charge all the profits of the taxpayer and not merely its assessable profits. Consequently the Full Court was able to conclude that section 16(1) authorised the deduction of all the expenses incurred in producing the whole profit of the respondent; and inferentially that section 17(1) did not exclude any part of those expenses.

The appellant in contesting the Full Court's decision submits that the Ordinance neither speaks of nor provides for chargeable profits as distinct from assessable profits. He says that the respondent, being a company carrying on business in the Colony, by dint of sections 14(1) and 18A of the Ordinance aided by its definitions of "assessable profits" and "profits arising in or derived from the Colony" in section 2, is clearly liable to be charged profits tax under Part IV upon assessable profits for the respective years of assessment ascertained in accordance with Part IV. He says that section 26(a) is not merely to be found in Part IV but forms part of the process of ascertainment thereunder of assessable profits. By virtue of that section the dividends received by the respondent in the years of assessment cannot be included in the profits thus to be calculated. Their exclusion, he says, is part of the calculation of assessable profits in accordance with Part IV, and in this connection calls attention to the definition of assessable profits in section 18A. For that reason the dividends are not profits, nor do they form a constituent of the profits, in respect of which the respondent is "chargeable to tax" under Part IV within the meaning of those words in sections 16(1) and 17(1). Consequently, says the appellant, the expense of deriving those dividends cannot fall within section 16(1) and inevitably falls within section 17(1)(b).

The respondent's reply is that there is a radical distinction drawn in the Ordinance between what the respondent describes as "chargeable" profits and assessable profits. It says that section 14(1) is the charging section of the Ordinance and in terms charges the profits of the company which the respondent submits means the whole profits of the taxpayer worked out on an ordinary commercial basis, though presumably limited to profits arising in or derived from the Colony. These profits which clearly enough would include the dividends are, in the respondent's submission, the "chargeable" profits. Consequently, so its argument runs, they are the profits in respect of which the respondent is chargeable to tax and the profits to which sections 16(1) and 17(1) refer. Therefore, says the respondent, all the expenditure incurred in producing those profits falls within section 16(1) and is deductible. The respondent submits that

the effect of section 26 (a) is not to remove the dividends from the profits of which section 14 (1) speaks, and in this connection it calls attention to what it claims to be the different treatment of profits arising from the sale of capital assets which are excluded by the definition of assessable profits, and the treatment of the dividends in the language of section 26 (a). It says that that section merely works at the terminal point of the process of determining the amount to which the rate of tax is to be applied, that is to say, it applies only when at that point the amount of the tax is being assessed.

It is clear from this brief recital of the principal arguments of the parties that unless the respondent can maintain the distinction in the Ordinance between chargeable and assessable profits it must fail in its claim to deduct the whole of its expenses. The whole of them was not wholly and exclusively incurred in producing the assessable profit.

But though in an earlier form the Ordinance did speak of chargeable income and chargeable profits, see section 19 of the Ordinance as in 1947, that description of profits does not occur in the 1956 re-print of the Ordinance which governs this appeal. It is the company which is chargeable to tax though in respect of certain profits only. Its liability to be charged profits tax is derived, in their Lordships' opinion, from a combination of section 14(1) and section 18A and not simply from section 14 (1). In their Lordships' view the function of section 14 (1) in the Ordinance as presently framed is to specify the companies which are to be liable to profits tax and the source of the profits which are to be brought to tax. Section 18A complements this function of section 14 (1) and indicates precisely what profits are to be brought to tax. It nominates the assessable profits as the profits in respect of which the company is chargeable to tax. And it expressly imposes the charge thereon and specifies the rate of tax. In their Lordships' opinion section 18A operates to define "the profits of the company" to which section 14 (1) refers. The words "subject to the provisions of this Ordinance" in section 14 (1) and the history of the amendment of the Ordinance to which reference will later be made each aid this conclusion. This relationship of section 14 (1) and section 18A does not appear to have been adverted to in the Supreme Court where, indeed, little reference was made in the judgments to section 18A.

Sections 16, 17 and 26 (a), in their Lordships' opinion, are part of the provision by the Ordinance for the process of ascertaining or computing the sum upon which the amount of profits tax payable by a company in a year of assessment will be calculated. It is clear enough that sections 16 and 17 provide exhaustively for the deduction side of the account which is to yield the assessable profits. They relate deductibility to the production of profits in respect of which the company is chargeable to tax which by section 18A are the assessable profits calculated in accordance with Part IV. Section 16 (1) does not provide for the deduction of expenses from the assessable profits but for the deduction of expenses "for the purposes of" the ascertainment of assessable profits. Its terms pre-suppose receipts from which deductions can be made to determine a balance which will be the assessable profit. On the other side of the account are the total receipts derived from the Colony not being from the sale of capital assets, see section 2 and section 14 (2), and not being dividends which, in their Lordships' opinion, are excluded from the account by section 26 (a). It is the balance of this account which, in their Lordships' opinion, is spoken of as the "net profits" in the definition of assessable profits in section 2.

Having regard to these provisions there is no room, in their Lordships' opinion, for treating the profits to which section 14 (1) refers as the balance of the total receipts over the total disbursements of the taxpayer arrived at upon ordinary business accounting considerations or for commencing the process of calculating assessable profits with an opening figure of the total of the business receipts and thereafter deducting the permitted deductions making the deductibility referable to the business

receipts and not to the receipts forming part of the assessable profits. Indeed the use of the word "profits" as distinct from receipts in section 14(1) is inconsistent with any such conclusion or process. In relation to the facts of this case, this means that on the one hand the dividends and on the other hand the expense of "producing" them are excluded from the computation.

Their Lordships observe that in the Supreme Court some stress was laid upon the absence of any provision for the apportionment of expenses as telling against the construction of the Ordinance for which the appellant has contended, but in their Lordships' view the absence of any such provision is not a relevant consideration in the construction of the provisions of the Ordinance now under consideration. As has been pointed out, sections 16 and 17 provide exclusively for the items which may be deducted from receipts when ascertaining the assessable profits. It rests upon the taxpayer to identify these items, quantifying them where dissection is necessary by some method which yields a logical, though perhaps in some cases only an approximate, result. The fact sought to be shown by any such method is the amount of the expenditure which can be said to be wholly and exclusively referable to the production of the receipts which would in some year of assessment form part of the assessable profits.

The successive amendments of the Ordinance since 1947 were adverted to by both Counsel each claiming to derive therefrom some assistance for his argument. As originally enacted the Ordinance contained in section 2 a definition of "profits" as meaning "the net profits for any period calculated in accordance with the provisions of Chapter 4 of this Ordinance but does not include profits arising from the sale of capital assets", but it had no definition of assessable profits. Section 15 was then in the same terms as the present 14(1) save that it specified the rate of tax as the standard rate, but no provision of the kind now found in section 18A was in the Ordinance. Section 17 was the counterpart of the present 16 and spoke of ascertaining "the profits" and of expenses wholly and exclusively incurred in the production of "the profits". Likewise, section 18(1)(b) (which has become 17(1)(b)) spoke only of ascertaining and of producing "the profits". In their Lordships' view it is quite clear that in 1947 section 14(1) brought to charge profits as thus defined and no other profits, that is to say, profits calculated in accordance with Part IV. Use of the definition with sections 17 and 18 would have confined the permitted deductions to those expenses which were incurred in producing profits calculated in accordance with Part IV. In their Lordships' view section 26(a) then formed and still forms part of the process of making that calculation. The direction that the dividends shall not be included in the assessable profits could not be carried out in their Lordships' opinion except by excluding dividends from the account of which the balance is to be the assessable profits. The dividends are not in the relevant sense a profit but a receipt. They could only be excluded from the account by their non-inclusion in the receipts against which the permitted deductions are to be made.

In 1955 the definition of "profits" was dropped from the Ordinance, the definition of "assessable profits" was inserted; the expression "assessable profits" was inserted in sections 16(1) and 17(1) where now appearing, and the word "such" was introduced in the expression "the production of such profits" in section 16(1) and in the expression "for the purpose of producing such profits" in section 17(1)(b). At the same time section 18A was inserted. In their Lordships' view it was inserted in part to perform the function of the former definition of "profits" particularly in relation to section 14(1). These amendments emphasised that only profits computed in accordance with Part IV fell within sections 14(1) and 16(1) and 17(1) in the 1955 re-print of the Ordinance.

However, in 1956 the expression in 16(1) "in the production of such profits" was substituted by the expression now appearing in 16(1), namely "in the production of profits in respect of which he is chargeable to tax under Part IV". The respondent submitted that if contrary to its submission it should be thought that the profits to which sections 14(1)

and 16 (1) referred prior to the 1956 amendment did not include dividends falling within section 26 (a), that the 1956 amendment of section 16 (1) effected a radical change so that thereafter because of the reference to chargeability, the profits described by section 14 (1) should be held to be the chargeable profits, that is to say, the entire business profit of the company and not the assessable profits as defined. But the amendment was quite inapt to effect such a substantial change in the structure of the Ordinance as the respondent suggests. Section 14 (1) with the meaning which it had both in the original Ordinance and in the 1955 re-print remained without amendment. In their Lordships' opinion, the intention of the amendment of section 16 (1), somewhat inartisticly expressed, was to expand the operation of that subsection to permit the deduction of expenses incurred in the basis year in the production of receipts which could form part of the assessable profits for some year of assessment in the future as well as expenses incurred in the basis year in the production of receipts which were actually included in the ascertainment of the assessable profits in the current year of assessment.

Such a distinction as the respondent seeks to draw between chargeable and assessable profits may have validity under some schemes of taxation with a different structure to the present, but in their Lordships' view with due respect to the Full Court it has neither validity nor significance under this Ordinance. Their Lordships can find no consequence which could be attached under the Ordinance to such a distinction. Their Lordships find no provision of the Ordinance inconsistent with the conclusion that the profits in respect of which a taxpayer may be at some time chargeable to tax under Part IV of the Ordinance cannot include dividends which fall within section 26 (a). It is to the production of such profits that the deductibility of items of expenditure are referable by virtue of sections 16 (1) and 17 (1).

Reference was made in argument to *Hughes v. Bank of New Zealand* 21 Tax Cases 472. That case does not seem to their Lordships apposite to the present. There the result was reached because the permissible deductions were described as those referring to a trade, which included the activity of producing income which by other provisions of the tax code there in question was not to be brought to tax. In contradistinction to that situation the permissible deductions in this code are described as those relating to the production of specific profits, namely, those in respect of which the taxpayer is, or may be, liable to pay profits tax. For these reasons their Lordships are of opinion that the appellant's argument is right and prefer the conclusion of the learned judge of first instance in the Supreme Court of Hong Kong to that of the Full Court.

Accordingly they will humbly advise Her Majesty that this appeal should be allowed, the judgment of the Full Court of the Supreme Court set aside and the judgment of the Supreme Court in its original jurisdiction restored. The respondent must pay the cost of the appeal to the Full Court. In accordance with the terms of the order granting special leave to appeal the appellant must pay the respondent's costs of this appeal to be taxed on a Solicitor and Client basis.

In the Privy Council

COMMISSIONER OF INLAND REVENUE

v.

MUTUAL INVESTMENT COMPANY
LIMITED

DELIVERED BY
SIR GARFIELD BARWICK

Printed by HER MAJESTY'S STATIONERY OFFICE PRESS
1966