

Court of Appeal clarified rules of attribution of directors' knowledge to companies in the context of tax assessments challenges

In the recent decision of the Court of Appeal (CA) in *Moulin Global Eyecare Trading Ltd v The Commissioner of Inland Revenue and Another* (CACV 64 of 2011), CA has clarified the legal principles governing the attribution of directors' knowledge to companies, and their application in the context of a challenge raised by the liquidators of a company in liquidation against profits tax assessments made based on fraudulently prepared financial accounts and tax returns.

Key issues

- Tax assessments challenges
- Attribution of directors' knowledge
- Agency law

Introduction

Section 70 of the Inland Revenue Ordinance (IRO) provides that:

"Where no valid objection or appeal has been lodged within the time limited by this Part [of IRO] against an assessment as regards the amount of the assessable income or profits or net assessable value assessed thereby, ... the assessment as made ... shall be final and conclusive for all purposes of this Ordinance as regards the amount of such assessable income or profits or net assessable value ..."

Generally, an objection to a tax assessment may be lodged pursuant to section 64 IRO, under which the objection must be lodged with the Commissioner of Inland Revenue (CIR) within 1 month after the date of the notice of assessment, subject to any extension granted by CIR upon reasonable cause being shown.

In *Moulin*, CA considered a situation where the profits tax payable by a company was allegedly over-assessed due to the fact that the company was fraudulently stated by its former directors in the relevant financial accounts and tax returns to be making profits (when it was in fact incurring losses). Essentially, the legal issue before CA was whether the knowledge of the fraudulent directors (in perpetuating preparation of fraudulent financial accounts and tax returns) could be attributed to the company. CA reversed the decision of the Court of First Instance (CFI) and answered the question in the affirmative.

Background

In *Moulin*, the taxpayer was a Hong Kong subsidiary of a global eyecare group. Upon presentation of a winding-up petition against the taxpayer on 21 June 2005, provisional liquidators were appointed on 23 June 2005. The taxpayer was subsequently ordered to be wound up on 5 June 2006, and the provisional liquidators were appointed as the liquidators by an order dated 28 August 2006.

On 29 August 2005, shortly after the provisional liquidators were appointed, the Inland Revenue Department (IRD) issued four notices of assessment for the years of 1999/2000, 2001/2002, 2002/2003 and 2004/2005. Subsequently, on 25 November 2005, IRD issued a further notice of assessment for the year of 2005/2006. The five aforementioned tax assessments (the Assessments) amounted to HK\$10,363,532 in total.

The liquidators did not lodge a formal objection against the Assessments until 13 November 2009 (long after the one-month time limit prescribed under section 64 of IRO had expired), for the reason that the taxpayer had been prevented from lodging the objection due to the concealment of the fraudulent conduct of the taxpayer's former directors. On the other hand, CIR's position was that the fraudulent knowledge of the taxpayer's former directors were attributable to the taxpayer, and accordingly the ground put forward by the liquidators did not amount to a reasonable cause capable of justifying the time extension sought by the liquidators.

The crucial legal issue before CFI, and subsequently before CA, was whether the fraudulent knowledge of the former directors was attributable to the taxpayer.

CFI's Judgment

CFI answered the question in the negative. Reyes J held that the fraudulent knowledge of the former directors should not be attributed to the taxpayer, in reliance on the English decision in *In re Hampshire Land Company*, which established the principle that the knowledge of an agent should not be attributed to the principal where it is acquired by the agent who is defrauding the principal in the same transaction.

CA's Judgment

CIR lodged an appeal against CFI's decision with CA. In its Judgment, CA explained the legal principles governing the attribution of directors' knowledge to companies.

In short, there are three ways by which directors' knowledge can be imputed to their companies:

1. The primary rules of attribution – to determine by reference to a company's articles of association or general company law the issue as to whose decision may bind the company, and to attribute the knowledge of those persons / bodies of persons to the company.
2. The general or agency rules of attribution – to attribute the knowledge of a company's duly appointed agents to the company, by virtue of the doctrine of agency and vicarious liability.
3. The special rules of attribution – default rules covering the situation where the primary or general/agency rules of attribution do not apply and the Court nevertheless considers that the knowledge of a person / body of persons should be attributed to the company (taking into account the particular purpose of and policy behind the substantive rule in question).

In light of the principles set out above, while CA agreed with Reyes J's view that the *Hampshire Land* principle should apply to exclude the applicability of the general/agency rules of attribution in *Moulin*, CA went on to hold that that Reyes J's decision was flawed in the sense that he had failed to consider the primary and special rules of attribution when he disposed of the matter at the first instance.

Turning to the facts of *Moulin*, CA further held that:

1. With reference to the taxpayer's articles of association, it could be said that the former directors in question were the directing mind and will of the taxpayer in preparing the relevant financial accounts. Accordingly, they were not merely acting as the taxpayer's agents, and their fraudulent knowledge could be imputed to the taxpayer by virtue of the primary rules of attribution.
2. In any event, in order to facilitate the statutory object of IRO to promote the finality of tax assessments and to avoid delay in raising objections, CA held that the knowledge of the former directors should be attributed to the taxpayer by way of the special rules of attribution.

3. As the taxpayer is primarily liable for its conduct (through the fraudulent knowledge imputed to it by its former directors), it cannot be said to have been acting reasonably or to have been "prevented" from giving notice of objection within time limit by its own fraud. Accordingly, CA allowed the appeal and upheld CIR's decision in refusing the time extension sought by the liquidators to lodge the objection against the Assessments.

There is one further noteworthy remark by Fok JA in delivering the CA Judgment: CA's finding that the knowledge of the former directors is attributable to the company does not mean that the creditors of that company are left without redress. In particular, he noted that the creditors may pursue an action for damages against the former directors for breach of fiduciary duties, or against the company's auditors for failure to exercise reasonable care to detect the fraud.

Conclusion

The latest CA decision in *Moulin* is significant for two reasons: firstly, it provides a useful analysis and illustration of the legal principles governing the attribution of directors' knowledge to companies. Secondly, in the context of challenges raised by taxpayers against assessments by IRD, it shows that the Court is prepared to readily apply the special rules of attribution to facilitate the statutory object of achieving finality of tax assessments within the prescribed timeframe.

It is not yet known whether the liquidators will seek to appeal against the CA decision to the Court of Final Appeal, and we will keep track of any developments.

Contacts

Brian Gilchrist

T: +852 2825 8878

E: brian.gilchrist@cliffordchance.com

Elaine Chen

T: +852 2825 8956

E: elaine.chen@cliffordchance.com

Kevin So

T: +852 2826 3477

E: kevin.so@cliffordchance.com

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Clifford Chance, 28th Floor, Jardine House, One Connaught Place, Hong Kong

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