

## HONG KONG COURT CHALLENGES LONG-ESTABLISHED PRACTICE OF THE COMMISSIONER OF INLAND REVENUE WHEN DEALING WITH AN OBJECTION TO TAX ASSESSMENT

A recent judgment from the Hong Kong Court of First Instance has challenged the long-established policies of the Inland Revenue Department and held that the Commissioner of Inland Revenue has a wide discretion when dealing with an objection to a tax assessment.

### BACKGROUND

Section 71 of the Inland Revenue Ordinance (Cap. 112) (the Ordinance) sets out the statutory scheme relating to the payment of tax pending an objection or appeal of a tax assessment. The Commissioner of Inland Revenue (the Commissioner) may order: (1) no hold over of tax, in which case, the tax remains to be payable immediately; (2) unconditional hold over of tax; or (3) conditional hold over of tax by the provision of security. The three options carry with them very different interest implications to the taxpayer.

In the situation where a no hold over order is made, the taxpayer is entitled to a refund of the tax paid should he succeed in his objection or appeal; the refund will however not be accompanied by any interest. If the Commissioner allows the tax to be held over on the condition that tax reserve certificates are purchased, upon successful objection or appeal, the taxpayer will be repaid the principal value of the certificates with minimal interest of 0.0433% per annum since 4 January 2010 (which has recently been adjusted to 0.0767% per annum with effect from 6 August 2018). On the other hand, if the Commissioner allows the tax to be held over unconditionally or held over conditionally by the provision of a banker's undertaking, should the taxpayer fail in his objection or appeal, he will have to pay the tax as assessed and interest on such sum at the District Court Judgment Rate, ie 8% per annum. A taxpayer who wishes to exercise their statutory right to object to a tax assessment faces some difficult options.

In *Dairyfarm Establishment & Anor v The Commissioner of Inland Revenue* [2018] HKCFI 2245, the applicants were Dairyfarm Establishment (DFE), a Liechtenstein incorporated entity and owner of certain trade marks registered in Hong Kong, and The Dairy Farm Company, Limited (DFCL), a Hong Kong incorporated private company which carries on its businesses in Hong Kong using the trade marks registered in the name of DFE. Pursuant to a Licence Agreement (the 2012 Agreement), in consideration of DFE granting DFCL a non-exclusive licence to use various trade marks in Hong Kong, DFCL pays

### Key issues

- The Hong Kong Court of First Instance has given guidance on the powers of the Commissioner of Inland Revenue regarding payment of tax pending objection or appeal.
- The Court has decided that the Commissioner of Inland Revenue has the power to annul or amend a validly issued tax assessment.
- The Court has also held that a single tax reserve certificate can be used as security for two sets of mutually exclusive, alternative assessments charging tax on the same profits.

royalties to DFE at a percentage of the gross sales turnover of the relevant businesses of DFCL.

For the years of assessments 2012/13, 2013/14 and 2014/15, the Commissioner took the view that the full amount of royalties received by DFE should be taxed under section 14 of the Ordinance (the Section 14 Assessments). Alternatively, but mutually exclusively, assessments were also issued pursuant to section 21A of the Ordinance on the basis that the full amount of royalties received by DFE should be taxed at the rate of 16.5% (the Section 21A Assessments). The Commissioner also denied DFCL's claim for deduction of the royalties when computing its assessable profits under sections 16, 61 and 61A of the Ordinance (the Section 61A Assessments, together with the Section 14 Assessments and Section 21A Assessments, the Assessments).

The objections lodged by the applicants were rejected notwithstanding that the Commissioner acknowledged that on any view, DFE and DFCL would ultimately only be liable to pay tax under either the Section 14 Assessments or the Section 21A Assessments as they are mutually exclusive. DFE and DFCL have appealed against the Determinations to the Board of Review which will be heard in March 2019 (the Appeals). Pending the Appeals, the Commissioner ordered a conditional holdover of tax due under the Assessments on the condition that tax reserve certificates be purchased in respect of the full amount of tax due under all the Assessments.

For the years of assessments 2015/16 and 2016/17, the Commissioner issued similar assessments to DFE and DFCL (the New Section 14 Assessments, the New Section 21A Assessments and the New Section 61A Assessments, together the New Assessments). DFE and DFCL lodged similar objections to the Commissioner in respect of the New Assessments. Pending the determination of these objections, proposals were put forward to the Commissioner (the Proposals) with a view to avoiding the provision of double security under the New Section 14 Assessments and the New Section 21A Assessments:

#### Proposal 1

(1) the New Section 21A Assessments be annulled (without prejudice to them being reissued within six years of the end of each relevant years of assessments); or

(2) the due date for the payment of the 2015/16 and 2016/17 final tax charged under the New Section 21A Assessments be postponed to two months after the final determination of the Appeals.

#### Proposal 2

Both the 2015/16 and 2016/17 final tax charged under the New Section 14 Assessments and that charged under the New Section 21A Assessments be held over on the condition that Tax Reserve Certificates be purchased pursuant to section 71(2) of the Ordinance for the larger sums of tax charged.

The Commissioner rejected the Proposals for the following reasons (the Decisions):

- (1) the Commissioner has no power to annul the New Section 21A Assessments once they have been validly issued;
- (2) the due date allotted for payment of the tax charged under the New Section 21A Assessments cannot be amended as the Commissioner

has no power to amend such due date and it is the Department's policy that it cannot be amended, and

- (3) the Tax Reserve Certificates are unique to each assessment and cannot serve as security for two sets of mutually exclusive, alternative, assessments on the same profits.

## THE COURT OF FIRST INSTANCE

DFE and DFCL challenged the Decisions by way of judicial review.

Before ruling on whether the Commissioner erred in law in rejecting the Proposals, the Court made four preliminary observations:

First, the Ordinance generally operates on the principle of "pay first, argue later". Second, the Commissioner enjoys a wide discretion in deciding whether to make a hold over order. Third, the Commissioner may, in appropriate circumstances, issue two or more mutually exclusive, alternative, profits tax assessments on different tax bases to a taxpayer for any particular year of assessment. Fourth, notwithstanding the disparities in the interest payable by the Commissioner and the taxpayer under the different scenarios as explained above, such disparities are authorised by legislation and have to be accepted as lawful and binding.

In relation to Proposal 1(1), the Court held that it is legally incorrect for the Commissioner to take the view that he cannot annul an assessment once it has been validly issued. Section 64(2) of the Ordinance gives the Commissioner a wide discretion to vary, including to annul, an assessment after receipt of a valid notice of objection, which is not confined to the situation where the Commissioner has made a determination on the actual objection (as argued by the Commissioner). Further, the Court also held that the Commissioner has power under section 46(c) of the Interpretation and General Clauses Ordinance (Cap. 1) (the IGCO), to "withdraw" the Section 21A Assessments, and there is nothing stopping the Commissioner from re-issuing the New Section 21A Assessments later after the final determination of the objection and appeal in respect of the New Section 14 Assessments (even if it is determined ultimately that they were incorrectly issued to DFE).

For Proposal 1(2), the Court held that the Commissioner has power under section 46(a) of the IGCO to amend the due date for payment even if such date has been specified in an assessment. The application of such power is not displaced by any contrary intention appearing in the Ordinance to establish a certain and predictable statutory scheme for handling objections and appeals.

Regarding Proposal 2, the Commissioner's position is that there is nothing in the Ordinance to permit him to accept tax reserve certificates purchased pursuant to the New Section 14 Assessments in payment of the tax payable under the New Section 21A Assessments upon the finalisation of the objection or appeal. This is because section 71(7)(e) of the Ordinance stipulates that each tax reserve certificate must include particulars of the tax assessment in dispute. The Court held that this is an overly rigid way to read the relevant statutory provisions. The tax reserve certificate is a standard form document, and there is no reason as to why the particulars of two sets of assessments in dispute cannot be appropriately stated in the blanks in the tax reserve certificate to make it clear that the certificate stands and is intended to stand as security for both assessments so as to comply with section 71(7)(e) of the Ordinance.

Having concluded that the Commissioner erred in law in rejecting the Proposals, the Court allowed the judicial review, quashed the Decisions and remitted the Proposals to the Commissioner for fresh consideration.

## **SIGNIFICANCE OF THE JUDGMENT**

This decision challenges the established policy of the Inland Revenue Department and confirms that the Commissioner has a wide discretion and power regarding payment of tax pending objection or appeal. Such decision is encouraging to taxpayers who receive multiple, and mutually exclusive, alternative assessments as they may now offer to purchase one tax reserve certificate as security for two sets of assessments charging tax on the same profits but on an alternative, mutually exclusive, basis.

Despite the Court holding that the Commissioner does have a wide range of powers and discretion available when dealing with proposals from taxpayers, such powers and discretion should be exercised properly and reasonably in line with usual principles.

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