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No Reprieve for Taxpayers where Fraudulent Profits Tax Paid

On 13 March 2014, the Court of Final Appeal (CFA) handed down its ruling in *Moulin Global Eyecare Trading Limited (In Liquidation) v. The Commissioner of Inland Revenue and Another* FACV 5/2013. The CFA dismissed the taxpayer's appeal and held that the taxpayer should be attributed with the guilty knowledge of the fraudulent directors such that it could not receive a time extension to give notice of objection to an assessment under section 64(1)(a) or correct an "error" in a return under section 70A of the Inland Revenue Ordinance (IRO).

The CFA's decision provides an authoritative ruling on the extent to which a director's or employee's knowledge may be attributable to the taxpayer company. It also defines and limits the scope of the "fraud exception" to the rule of attribution.

Background

(For a more detailed summary of the case, please refer to our legal updates "Court of Appeal's Recent Tax Decisions" of 27 June 2012, and "Constant Vigilance – Two Recent Tax Decisions" of 19 April 2013.)

The taxpayer company had previously prepared profits tax returns and paid over HK$88 million tax pursuant to inflated profit data in false accounts prepared by the fraudulent directors. Years later, the liquidators of the taxpayer company discovered that the taxpayer had in fact made no profit at all, and attempted to reclaim the profits tax paid to the Inland Revenue Department (IRD). Pursuant to sections 64(1)(a) and 70A of the IRO respectively, the liquidators contended the fraud was either a "reasonable cause" to extend the one-month time limit for objection, or an "error" in the returns which caused excess tax to have been paid.

The Court of First Instance (CFI), relying on the general law of agency, found in favour of the taxpayer, holding conclusively that an agent's fraud can never be attributed to his principal. The Court of Appeal (CA) overturned the CFI decision, on the basis that other rules of attribution that facilitated the statutory objects of the IRO should instead be applied. The taxpayer appealed to the CFA.

In the CFA

In a long and careful judgment, Lord Walker NPJ, writing for the majority, dismissed the appeal on the grounds of attribution of fraudulent knowledge to the taxpayer and public policy.

ATTRIBUTION AND THE FRAUD EXCEPTION

The CFA held that the scope of the fraud exception is limited and the attribution of an individual's knowledge to a company will always depend on the nature of the proceedings in which the attribution arises. This conclusion was reached by Lord Walker applying the recent English Court of Appeal decision of *Bilta (UK) Ltd v. Nazir* [2014] 1 All ER 168 and adopting a contrary position to His Lordship's own judgment in *Stone & Rolls* [2009] 1 AC 1391. Lord Walker classified such proceedings into three main categories:

- "Liability" cases, where the company is being sued by an injured third party due to the fraudulent conduct of the company's agents. The fraud exception will not apply as the company is responsible for the dishonest conduct of its employees, even if the company itself is also a "victim";
- "Redress" cases, where the company itself is suing its fraudulent directors or employees. The fraud exception applies as it would be absurd to allow a fraudulent director or employee to use the attribution of knowledge to shield themselves from liability; and
- Cases which are neither liability nor redress cases, such as claims against insurers or auditors who

have respectively undertaken to protect, or to use their professional skill, against fraudulent conduct. Here, the fraud exception will not apply to absolve such insurers or auditors of their contractual responsibilities who have undertaken to provide protection against or use reasonable professional skill to uncover the fraud.

Lord Walker held the IRD did not fit into either the "liability" or the "redress" categories, and was also markedly different from the position of an auditor or insurer. The IRD could not be expected to conduct inquiries into a taxpayer's business.

The CFA held that the fraud exception should not apply to the claim against the Commissioner and as such, the fraudulent knowledge of the directors would be attributed to the taxpayer.

As a result of the attribution of knowledge, the proviso to section 64(1) of the IRO would not apply as the taxpayer "chose not to" lodge an objection within time. Section 70A was also irrelevant as the tax assessments were in effect deliberate lies, instead of the "errors" required for that section to operate.

PUBLIC POLICY GROUNDS

In reaching its decision, the CFA noted that the IRD's functions, powers and obligations were found in the IRO and the public sphere. The IRO aimed to ensure a fair and efficient taxation system featuring prompt payment and finality within a reasonably short time. This statutory purpose would be frustrated if the fraud exception extended to cover claims to indirectly recoup losses suffered as a result of misconduct by a director or employee.

DISSENT ON S70A

Mr. Justice Tang PJ disagreed with the majority regarding the application of the fraud exception in regard to section 70A of the IRO. His Lordship adopted a pragmatic approach and held that if the liquidators were able to prove the fraud of the directors, then "justice and common sense" required the application of the fraud exception as the IRD had suffered no injury at all. Finally, Tang PJ also noted that under the majority's ruling, shareholders in companies with negligent management would be better off than shareholders in companies with fraudulent management, even though the former type of mismanagement is far more common.

Comments

The CFA has adopted a narrow view of the fraud exception to attribution of knowledge and chosen to take a broad public policy approach to ensure finality of tax assessments, even where creditors stand to lose over HK$88 million in tax paid on false profits.

While the decision clarifies important aspects in the law of attribution, the key takeaway for the taxpayer is that unnecessary tax liabilities stemming from the fraudulent activity of directors will, in most cases, be irretrievable from the Commissioner. Even if the responsible individuals such as auditors or liquidators are able to discover the fraud within the short time frames allowed by tax law, the taxpayer company may still be forced to pay tax it would not otherwise have had to pay.

Contact Us

For more information about this Legal Update or for an informed opinion on your taxation options following this landmark decision of the Court of Final Appeal, please contact the following persons or your usual contacts with our firm.

Susanne Harris
Partner
T: +852 2843 4522
E: susanne.harris@mayerbrownjsm.com

Simon Au
Associate
T: +852 2843 2564
E: simon.au@mayerbrownjsm.com

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