No refund of tax paid due to fraudulent conduct of directors.

The Court of Final Appeal clarifies the rules of attribution of directors' knowledge to a company and their application to a claim by liquidators against over-assessed tax based on fraudulently prepared financial accounts and tax returns.

The Court of Final Appeal (*CFA*) recently delivered judgment in *Moulin Global Eyecare Trading (in Liquidation) v The Commissioner of Inland Revenue (FACV No 5 of 2013)*. The case addressed complex issues concerning attribution to a company of the fraud of certain of its directors. It also dealt with specific points of construction of the Inland Revenue Ordinance (*IRO*).

The Court considered the position where profits tax payable by a company was over-assessed because the directors had fraudulently misstated financial accounts and tax returns. The issue before the CFA was whether the knowledge of the fraudulent directors (in perpetuating preparation of fraudulent financial accounts and tax returns) could be attributed to the company.

Background

Moulin Global Eyecare Trading *(Moulin*) ceased trading in 2005 and was ordered to be wound up in June 2006. Upon their provisional appointment, the liquidators discovered serious discrepancies in Moulin's accounts. Some of its former directors, who were later convicted of fraud amounting to HK$4.45 billion, had inflated the company's profits through fictitious sales. Profits tax returns were submitted based on the falsified accounts for 6 years of assessment and the company paid almost HK$89 million in profits tax. The true situation was that Moulin had made no profit from the 1998/99 tax year onwards. The liquidator, consequently, sought to reclaim the profits tax paid to the Inland Revenue Department (*IRD*) on the basis that the company did not genuinely make any taxable profits in the relevant years and the reported profits were, therefore, equally false.

The liquidators' claim, on behalf of the company, was based on the following:

i. *Section 64 of the IRO*: An application for an extension of time to object to the assessments made during the relevant tax years on the ground that the fraudulent conduct of its directors had prevented Moulin from giving notice of objection within the one month statutory limit, and

ii. *Section 70A of the IRO*: An application for the Commissioner to correct an assessment within the six year time limit assessment if the tax charged is excessive by reason of an error in the tax return. Moulin contended, only in respect of the 2003/2004 tax year, that tax was overpaid due to errors in the return because the directors had deliberately and fraudulently overstated the company's profits.

The Commissioner rejected the liquidators' application on the grounds that the relevant returns were filed by the company with knowledge of the fraud.

On the liquidators' application for judicial review, in February 2011, the Court of First Instance (CFI) ([2011] 3 HKLRD 216), relying on the general law of agency, found in favour of Moulin, holding that an agent's fraud can never be attributed to his principal (Moulin),and ordered the Commissioner to reconsider her decisions. In March 2012, the Court of Appeal (CA) ([2012] 2 HKLRD 911) allowed the Commissioner's appeal and set aside the CFI's orders. The CA concluded that alternative rules of attribution that facilitated the statutory intent of the IRO should be applied. It held that the fraudulent knowledge of Moulin's directors that the profits had been falsely overstated should be attributed to the company. Consequently, Moulin had not been prevented from giving notice of objection within the stipulated time (section 64(1)(a)) nor was there any error within the meaning of section 70A. The CA granted leave to appeal so that the law relating to attribution could be considered and authoritatively stated by the CFA.

The outcome

The CFA, placing great reliance on the attribution of fraudulent knowledge to Moulin as well as issues of public policy, unanimously dismissed the appeal under section 64(1)(a) and, by a majority (Tang PJ dissenting), dismissed the appeal under section 70A.

Having reviewed the facts and the language and legislative purpose of the statutory provisions contained in the IRO, the Court held that the knowledge of the fraudulent directors should be attributed to Moulin. The leading (and lengthy) judgment of Lord Walker of Gestingthorpe NPJ includes a detailed restatement of the *law of attribution* of the fraud of directors of a company to the company itself and defined the limits and scope of the *fraud exception* to the attribution rules (which is where the company seeks to be insulated from the knowledge of its fraudulent directors where the company is the victim of the fraud).

The Court acknowledged the importance of having a fair and efficient tax system which can be expected to produce public revenue to a more or less predictable level. Equally, prompt payment and finality within a reasonably short time were important policy aims of the provisions of the IRO being addressed in this appeal.

As it is an essential part of the scheme of the IRO that the Commissioner is able to make assessments on the basis of the taxpayer's returns, it would frustrate this statutory purpose if the fraud exception were to intrude into this scheme. Lord Walker therefore concluded that the fraud exception must be limited to its proper, limited role of barring unmeritorious defences in claims by corporate employers against dishonest directors or employees and their accomplices.

Consequently, the CFA held that the fraud exception should not apply to the claim against the Commissioner and the fraudulent knowledge of the directors would be attributed to the taxpayer. As a result, the liquidators could not rely on the proviso in section 64 because the Moulin was not "prevented" from lodging an objection in time: it chose not to do so. Nor could the liquidators rely on section 70A, because Moulin, knowing that the return was false, had not made an "error" in the return but had instead told a deliberate lie in it.

Conclusion

The decision of the CFA is significant for two reasons: Firstly, it clarifies the legal principles governing the attribution of directors' knowledge to a company while adopting a narrow interpretation of the fraud exception to such attribution of knowledge. Secondly, the Court has taken a broad public policy approach to ensure the finality of assessments within the statutorily intended timeframe, even if creditors may lose substantially through overpaid tax on falsified profits.

The importance to taxpayers of this decision is that overstated tax liabilities arising from the fraudulent conduct of directors will not, in most cases, be recoverable from the Commissioner notwithstanding the fact that auditors and/or liquidators may discover such fraud within the limited time allowed by the law.

KPMG
cutting through complexity

CONTACTS

Khoon Ming Ho
Partner in Charge, Tax
China and Hong Kong SAR

Tel: +86 10 8508 7082
khoonming.ho@kpmg.com

Ayesha M. Lau
Partner in Charge, Tax
Hong Kong SAR

Tel: +852 2826 7165
ayesha.lau@kpmg.com

Chris Abbiss
Partner

Tel: +852 2826 7226
chris.abbiss@kpmg.com

Darren Bowdern
Partner

Tel: +852 2826 7166
darren.bowdern@kpmg.com

Barbara Forrest
Principal

Tel: +852 2978 8941
barbara.forrest@kpmg.com

Daniel Hui
Principal

Tel: +852 2685 7815
daniel.hui@kpmg.com

Charles Kinsley
Principal

Tel: +852 2826 8070
charles.kinsley@kpmg.com

John Kondos
Partner

Tel: +852 2685 7457
john.kondos@kpmg.com

Alice Leung
Partner

Tel: +852 2143 8711
alice.leung@kpmg.com

Curtis Ng
Partner

Tel: +852 2143 8709
curtis.ng@kpmg.com

Kari Pahlman
Principal

Tel: +852 2143 8777
kari.pahlman@kpmg.com

Murray Sarelius
Partner

Tel: +852 3927 5671
murray.sarelius@kpmg.com

John Timpany
Partner

Tel: +852 2143 8790
john.timpany@kpmg.com

Wade Wagatsuma
Partner

Tel: +852 2685 7806
wade.wagatsuma@kpmg.com

Lachlan Wolfers
Partner

Tel: +852 2685 7791
lachlan.wolfers@kpmg.com

Chris Xing
Partner

Tel: + 852 2978 8965
christopher.xing@kpmg.com

Karmen Yeung
Partner

Tel: +852 2143 8753
karmen.yeung@kpmg.com

Kate Lai
Director

Tel: +852 2978 8942
kate.lai@kpmg.com

Alex Lau
Director

Tel: +852 2143 8597
alex.lau@kpmg.com

Benjamin Pong
Director

Tel: +852 2143 8525
benjamin.pong@kpmg.com

Adam Zhong
Director

Tel: +852 2685 7559
adam.zhong@kpmg.com

Justin Pearce
Senior Tax Advisor

Tel: +852 2143 8756
justin.pearce@kpmg.com