

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D19/99

Profits Tax – service company – management fee – whether deductible in computing the assessable profit – Practice Note No. 24 – Inland Revenue Ordinance, Chapter 112, section 16, 17, 61, 64, 68(4) and Rule 2A(1) of the Inland Revenue Rules.

Panel: Mathew Ho Chi Ming (chairman), Melville Thomas Charles Boase and Archie William Parnell Jr.

Date of hearing: 12 April 1999.

Date of decision: 31 May 1999.

The taxpayer commenced his profession as a barrister-at-law in Hong Kong on 1 January 1991, Company B was incorporated as a private company in Hong Kong on 20 September 1988. Company B commenced business on 1 January 1991. At all relevant times, the taxpayer and his wife were shareholders and directors of Company B. The disagreement between the assessor and the taxpayer arises from the tax treatment of the management fees paid to Company B in the two years of assessment in question. The taxpayer says that it is completely deductible. The assessor considered that the management fees charged in the taxpayer's accounts should only be allowed for deduction to the extent that they reflected those costs directly attributable to the operations of the taxpayer's profession plus an appropriate mark-up. The assessor says that this was in accordance with the Departmental Interpretation and Practice Note No. 24 issued by the Commissioner of Inland Revenue in August 1995.

The issues to be decided are:

- (a) whether and how section 61 applies to the present case.
- (b) Irrespective of whether section 61 applies or not, whether the assessor and the Commissioner's determination was correct in disallowing various disallowed expenses categories in the profit and loss account of Company B.

The taxpayer's grounds of appeal includes (1) Section 61 of the IRO does not apply because the transaction were artificial nor fictitious. Company B is not artificial or fictitious It is a separate legal entity with its own independent existence. (2) The various expenses queried by the Revenue were actual expenses. Company B was legally liable to pay such expenses. (3) The disallowed items were arbitrary. (4) The Practice Note 24 has changed the law.

INLAND REVENUE BOARD OF REVIEW DECISIONS

Held:

1. Practice Note No. 24 did not change the law. It was a warning that Type II service company arrangements will be scrutinized by the Revenue and sets out the legal weaponry at its disposal to attach such arrangements.
2. While the concept of separate legal entities for corporations is a corner stone of our laws, there are exceptional situations where the corporate veil available to Company B is lifted by section 61 or by the dissection of the management fees under section 16 (CIR v Douglas Howe 1 HKTC 936 and Littlewoods Mail Order Stores Ltd v IRC [1969] 1 WLR 1241 considered and applied).
3. Whether section 61 applies to service company arrangement depends on whether any artificial or fictitious transaction exists. If service company arrangement is to be disregarded in accordance with section 61, then it is open to the Revenue to assess the chargeable profits of a taxpayer by totally ignoring service company and the service fees. With service company and service company arrangement out of the way (in other words, after lifting the corporate veil), it is open to the Revenue to dissect the outgoing expenses of service company as if such outgoing or expenses were that of a taxpayer in the light of whether such outgoing or expenses were deductible to the extent to which they are incurred in the production of a taxpayer's chargeable profits.
4. A properly and commercially structured service company arrangement is neither artificial nor fictitious. If the taxpayer can satisfy the Board that the nature of the service provided by Company B were genuine and commercially realistic and that the payment of the service fee by the taxpayer was for the services provided by Company B, there is no reason whatsoever that section 61 shall apply. It is incumbent on the Board to look at the individual circumstances and evidence of each service company arrangement in any appeal and to reach its own conclusion as to the applicability of section 61.
5. Applying the above legal principles, the Board found that there is nothing artificial or fictitious about the existence of Company B. The service agreement itself was not fictitious. It exists and is legally enforceable. What the Board needed to decide was whether the service company arrangement, the *raison d'être* of the service agreement, is artificial or fictitious. The Board did not consider the service company arrangement was fictitious as the arrangement existed. However, having considered the facts, the documents and submissions submitted, the Board concluded that the transaction, viz, service company scheme or operation underlying

INLAND REVENUE BOARD OF REVIEW DECISIONS

the service agreement and Company, is artificial and commercially unrealistic:

- (1) The shareholders and directors of Company B were the taxpayer and his wife. There were no other shareholders or directors;
 - (2) Company B had no other clients; the sole source of income being the service fees paid by the taxpayer;
 - (3) There is no evidence on what were the actual services provided by Company B. The service agreement attempted to include all and any possible service. This blanket approach served to illuminate the artificiality of service company arrangement. It was commercially unreal. Had the services been more specific or confined to support services related to the taxpayer's business as a practising barrister, and assuming there were no other adverse factors, service company arrangement would have been commercially real;
 - (4) Further, a detailed analysis of the expenses tends to show that the disallowed expenses were domestic or private in nature and did not related to the services contemplated under the service agreement. For example, the expense relating to restaurants, resort hotel, package tours, air fares and medical fees were personal and private in nature. Thus, even if the service arrangement under the service agreement were commercially real, the actual performance and implementation of the arrangement was flawed.
6. Having found that the present service arrangement is artificial, the Board followed previous Board decisions that of the dissection of management fees can be done, then the adjustments will be made to analyse the expenses of the service company and disallow those expenses not related to a taxpayer's chargeable profits:
- (1) The boating expenses, the travelling expenses, medical expenses and entertainment expenses were personal or private and hence not deductible;
 - (2) Section 17(a) and (f) operates to disallow domestic and private expenses and rent or expenses in connection with any premises or part of premises not occupied or used for the purpose of producing profits. The taxpayer failed to discharge his onus under section 64(4) to establish that his study was used primarily and perhaps exclusively for his practice. Even with the necessary facts established, the taxpayer would still have to overcome the view that one does not look at use to which the study is put but at the character

INLAND REVENUE BOARD OF REVIEW DECISIONS

of the study. It does not cease to be a part of the taxpayer's home merely because, as a matter of convenience, he uses it on certain times for the purpose of generating his chargeable profit (Handley v Federal Commissioner of Taxation 11 ATR 644 applied).

- (3) No evidence was produced on whom the salaries and directors remuneration were paid and why they were paid. Prime facie, these expenses have not been established by the taxpayer to relate to the production of his chargeable profits.
- (4) Hence all expenses relating the upkeep of Company B (the professional fee and audit fees, the directors' remuneration) were not deductible vis-a-vis the taxpayer. It also follows the argument that because an expense item was deductible from the chargeable profits of Company B and therefore it is deductible as a chargeable profit of the taxpayer must fail.
- (5) Further, as Company B is to be disregarded under section 61, logically, the mark-up (whether it be 12.5% usually given by the Revenue or the 5% charged under the service agreement) for those deductible expenses conceded by the Revenue should also not be deductible. However, the Board did not disturb the concession on the 12.5% mark-up granted by the Revenue to the taxpayer.

Obiter

1. Corporate veil can be lifted even if no view of artificiality of service company arrangement can be formed.
2. Section 61 must be applied first before the expense dissection can take place.
3. Even if the service company arrangement was not artificial or fictitious, it is still open to the Revenue to dissect service company's expenses (D61/91 and D32/93 applied). Thought it is difficult to apply the management fee dissection without first concluding that service company arrangement was artificial or fictitious.
4. The apportionment provision in Rule 2A(1) of the Inland Revenue Rules could not form the basis of the management fee dissection.
5. Where circumstances exist to raise doubts on a service company arrangement, one would further test the commercial reality and genuineness of service company arrangement by looking at the expenses of service company. One may find that service company expenses are

INLAND REVENUE BOARD OF REVIEW DECISIONS

private or domestic or are expenses not related to the services provided. This analysis of service company's expenses is, in fact, a dissection of service company's expenses. Hence, in a manner of speaking, one goes through a process or analysis similar to a management fee dissection which combined with other circumstances of the case, will lead one to conclude whether a service company arrangement is artificial or not. If one concludes that the arrangement is artificial, then only those expenses of the now discarded service company which relate to the generation of a taxpayer's chargeable profit (that is the so-called dissection of management fee) are allowed. In other words, the dissection of service company's expenses (akin to the dissection of management fee) is one of the tools used to determine whether an arrangement is artificial or not; if it is artificial, then the Revenue can use the management fee dissection method to apportion the management fee paid to service company and allow only those expenses which generated a taxpayer's chargeable profit. This practice of dissecting management fees irrespective of whether section 61 applies has been applied by the Board (D32/94 applied).

Appeal dismissed.

Cases referred to:

Saloman v A Saloman & Co Ltd [189] AC 22
China Ocean Shipping Co v Mitsui Bussan Kaisha Ltd [1995] 3 HKC 125
Macaura v Northern Assurance Co Ltd [1925] AC 619
Terrain Ltd and Ors v Oriental Peer Co Ltd [1988] 1 HKLR 246
Lee v Lee's Air Farming Ltd [1960] 3 All ER 420, [1961] AC 12
Re FC (Films) Ltd [1953] 1 WLR 483, [1953] 1 All ER 615
JH Rayner (Mincing Lane) Ltd v Dept of Trade and Industry [1988] 3 All ER 257,
[1989] Ch 72
Good Profit Development Ltd v Leung Hoi [1992] 2 HKC 539, [1993] 2 HKLR 176
Wharf Properties Ltd v CIR, Privy Council Appeal No 40 of 1996, HKLR 1997, 252
CIR v Douglas Howe 1 HKTC 936
D61/91, IRBRD, vol 6, 457
D32/93, IRBRD, vol 8, 261
D32/94, IRBRD, vol 9, 97
D110/98, IRBRD, vol 13, 553
Handley v Federal Commissioner of Taxation, 11 ATR 644
Littlewoods Mail Order Stores Ltd v IRC [1969] 1 WLR 1241
D44/92, IRBRD, vol 7, 324
D96/89, IRBRD, vol 6, 372
CIR v The Duke of Westminster [1936] AC 1

INLAND REVENUE BOARD OF REVIEW DECISIONS

Chan Wai Mi for the Commissioner of Inland Revenue.
William H Areson Jr of Messrs Areson & Co for the taxpayer.

Decision:

Nature of appeal

1. Mr A ('the Taxpayer') has objected to the additional profits tax assessment for the year of assessment 1994/95 and the profits tax assessment for the year of assessment 1995/96 raised on him. The Taxpayer objected to the assessments as excessive and asserted that certain management fees should be deductible in computing the assessable profits for the years. The Commissioner of Inland Revenue made a determination under section 64 of the Inland Revenue Ordinance ('the IRO') confirming the additional profits tax assessment for the year of assessment 1994/95 with additional assessable profits of \$896,169 and additional tax of \$134,426 and increasing the profits tax assessment for the year of assessment 1995/96 to assessable profits of \$1,398,077 with tax payable thereon of \$209,711.

Agreed facts

2. The parties have agreed to the following facts (except where otherwise mentioned):

- a. The Taxpayer commenced his profession as a barrister-at-law in Hong Kong on 1 January 1991.
- b. Company B was incorporated as a private company in Hong Kong on 20 September 1988. Company B commenced business on 1 January 1991. At all relevant times, the Taxpayer and his wife were shareholders and directors of Company B.
- c. In his tax return for the year of assessment 1994/95, the Taxpayer declared assessable profits of \$445,591, which was arrived at after deducting management fees of \$1,496,154. The Taxpayer claimed that the management fees were paid to Company B for the provision of management services.
- d. The assessor raised on the Taxpayer the following profits tax assessment for the year of assessment 1994/95 subject to enquiries being raised:

Profits per return	\$445,591
Tax payable thereon	\$66,838

INLAND REVENUE BOARD OF REVIEW DECISIONS

- e. In reply to enquiries raised by the assessor, Company C claimed that the management fees were paid to Company B for technical, managerial and administrative services provided in accordance with a management services agreement dated 1 January 1991 ('Service Agreement').
- f. It is stated at Clause (3) of the Service Agreement that:

'In consideration for the service, (Company B) shall be entitled to reimbursement of all expenses and outgoings whatsoever (including, without limitation, depreciation or maintenance of capital assets) suffered or incurred in connection with the provision of the services to the Taxpayer on a full indemnity basis AND a service fee equivalent to five (5) percent of all such expenses and outgoings. (Company B's) remuneration pursuant to this Clause (3) shall be calculated on a monthly basis at the end of each calendar month and shall be paid by the Taxpayer within twenty (20) days of the relevant invoice being raised.'

- g. On divers dates, Company B filed its profits tax returns for the years of assessment 1994/95 and 1995/96 with accounts. Details of its Profit and Loss Accounts are as follows:

Year ended	31 March 1995	31 March 1996
	\$	\$
Management fees earned	1,496,154	1,489,986
Sundry income	---	300
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	1,496,154	1,490,286
 <i><u>Less</u> : Administrative and general expenses</i>		
Rent, rates and management charges	460,626	571,513
Travelling expenses	151,490	97,882
Directors' remuneration	137,000	150,800
Salaries	42,000	42,000
Insurances	38,978	5,920
Medical expenses	30,109	16,506
Telephone and paging	13,363	26,682
Electricity, water and gas	12,335	11,158
Newspapers and periodicals	2,296	---

INLAND REVENUE BOARD OF REVIEW DECISIONS

Entertainment	246,742	217,401
Chambers expense	161,000	180,000
Professional fees	19,692	14,350
Motor vehicle expenses	14,189	17,055
Boat expenses	12,000	12,000
Sundry expense	9,954	12,848
Audit fee	8,200	8,600
Hire purchase interest	7,281	---
Bank charges	948	250
Printing, stationery and postages	250	1,600
Depreciation	56,455	32,833
	<u>1,424,908</u>	<u>1,419,034</u>
Profit before taxation	<u>71,246</u>	<u>71,252</u>

- h. The assessor considered that the management fees charged in the Taxpayer's accounts should only be allowed by deduction to the extent as they reflect those costs directly attributable to the operations of the Taxpayer's profession plus an appropriate mark-up. The assessor raised on the Taxpayer the additional profits tax assessment for the year of assessment 1994/95. (Note : The facts in this sub-paragraph is not agreed by the Taxpayer and is stated here for the sake of continuity of the agreed facts.)
- i. Company C, on behalf of the Taxpayer, objected to the additional profits tax assessment. Company C contended that:
- i. Company B was a separate legal entity distinct from the Taxpayer. The management fees equivalent to 5% of all the expenses and outgoings charged for the provisions of services were accepted by both Company B and the Taxpayer and were considered to be commercially realistic for the services provided.
 - ii. The arrangement was legally documented and appropriate accounts had been kept in computing the management fees.
 - iii. The management fees should be deductible under section 16 of the IRO.
- j. The Taxpayer failed to file his tax return for the year of assessment 1995/96 within the stipulated period. The assessor raised on the Taxpayer

INLAND REVENUE BOARD OF REVIEW DECISIONS

the following profits tax assessment for the year of assessment 1995/96 in the absence of a return:

Estimated assessable profits	\$534,710
Tax payable thereon	\$80,206

- k. The Taxpayer, through Company C, objected against the profits tax assessment for the year of assessment 1995/96. In support of the objection, the Taxpayer filed his return and declared an assessable profit of \$434,665. The figure was arrived at after deducting management fees of \$1,489,986. The Taxpayer claimed that the management fees were paid to Company B for the provision of management services.
- l. The accounts for the years ended 31 March 1995 and 1996 filed by the Taxpayer in respect of his profession showed the following particulars:

Year ended	31 March 1995	31 March 1996
	\$	\$
Fee income	<u>1,948,495</u>	<u>1,932,401</u>
<i>Less : Expenses</i>		
Management fees paid	1,496,154	1,489,986
Accountancy charges	3,500	3,500
Business registration	2,250	2,250
Practising certificate	1,000	1,000
Insurances	---	1,000
	<u>1,502,904</u>	<u>1,497,736</u>
Profit for the year	<u><u>445,591</u></u>	<u><u>434,665</u></u>

- m. Company D provided the following information in respect of expenses charged in the accounts of Company B:
- i. The expenses under rent, rates, and management charges represents the quarters expenses of the directors of Company B. Due to the urgent nature of court business, the Taxpayer is frequently obliged to work from home premises especially at evening, weekends and public holidays. One room of his three bedroom flat is fitted out as a study with a desk, law books, telephone/fax, ... etc. and accordingly plays a significant part in the assessable produced by the Taxpayer.

INLAND REVENUE BOARD OF REVIEW DECISIONS

- ii. The Taxpayer and his wife, being directors of Company B, are entitled to annual holidays and travelling expenses were incurred by them in the capacity of the company's employees.
- iii. Electricity, water and gas were expended on the directors' quarters.

Background in addition to agreed facts

3. The disagreement between the assessor and the Taxpayer arises from the tax treatment of the management fees paid to Company B in the two years of assessment in question. The Taxpayer says that it is completely deductible.

4. The assessor considered that the management fees charged in the Taxpayer's accounts should only be allowed for deduction to the extent that they reflected those costs directly attributable to the operations of the Taxpayer's profession plus an appropriate mark-up. The assessor says that this was in accordance with the Departmental Interpretation and Practice Note No 24 ('Practice Note 24') issued by the Commissioner of Inland Revenue in August 1995.

5. The assessor made management fee adjustments to calculate the true assessable profit of the Taxpayer. This was done by analysing the expenses of Company B and allowing from its profit and loss accounts those expense items which the assessor thinks are deductible as an outgoing or expense to the extent to which such outgoing or expense are incurred in the production of the Taxpayer's profit (rather than in the production of Company B's profit). For ease of reference, this process is termed dissection of management fee. A mark-up of 12.5% was allowed for those expenses which were deductible. The allowable deductible expense items are then deducted from the total management fee paid to Company B. The resulting figure is called the management fee adjustment which is treated as part of the assessable profit of the Taxpayer. The expenses of Company B appearing in its profit and loss accounts, the items which were allowed as deductible expenses of the Taxpayer by the Revenue and how the management fee adjustment was calculated are set out in the Table of Expenses hereto annexed.

6. The Taxpayer has elected not to give oral testimony. In reaching this decision, the Board has considered the agreed facts, the documents submitted by the Taxpayer and the Revenue and the submissions from both parties.

Applicable statutory provision

7. The applicable provision in the IRO which are relevant to this appeal are:
 - a. Section 16

INLAND REVENUE BOARD OF REVIEW DECISIONS

Section 16 ascertains the chargeable profits by defining which outgoings and expenses are deductible from the chargeable profits of a taxpayer. Section 16(1) allows to *'be deducted all outgoings and expenses to the extent to which they are incurred during the basis period ... in the production of profits in respect of which he is chargeable to tax under this Part for any period including ...'* Section 16(1) then sets out those expenses which are deductible.

b. Section 17

Section 17 sets out those deductions which will not be allowed and the relevant disallowed expenses are those deductions in respect of:

- '(a) domestic or private expenses, including the cost of travelling between residence and place of business;*
- (b) any disbursements or expenses not being money expended for the purpose of producing such profits;*
- (c) any expenditure of a capital nature or any loss or withdrawal of capital;*
- (d) ...*
- (e) ...*
- (f) rent of, or expenses in connection with, any premises or part of premises not occupied or used for the purpose of producing such profits.'*

c. Section 61

'Where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessable accordingly.'

8. Section 68(4) of the IRO states the burden of the onus of proof in this appeal:

'The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.'

Taxpayer's case

INLAND REVENUE BOARD OF REVIEW DECISIONS

9. The Taxpayer's submissions through its present representative, Mr Areson, can be summarized as follows:

- a. Section 61 of the IRO does not apply because the transactions were neither artificial nor fictitious. Company B is not artificial or fictitious. It is a separate legal entity with its own independent existence. The classic cases on corporate personality were cited to us:
 - i. Saloman v A Saloman & Co Ltd [189] AC 22.
 - ii. China Ocean Shipping Co v Mitsui Bussan Kaisha Ltd [1995] 3 HKC 125.
 - iii. Macaura v Northern Assurance Co Ltd [1925] AC 619.
 - iv. Terrain Ltd and Ors v Oriental Peer Co Ltd [1988] 1 HKLR 246.
 - v. Lee v Lee's Air Farming Ltd [1960] 3 All ER 420, [1961] AC 12.
 - vi. Re FC (Films) Ltd [1953] 1 WLR 483, [1953] 1 ALL ER 615.
 - vii. JH Rayner (Mincing Lane) Ltd v Dept of Trade and Industry [1988] 3 All ER 257, [1989] Ch 72.
 - viii. Good Profit Development Ltd v Leung Hoi [1992] 2 HKC 539, [1993] 2 HKLR 176.
- b. Not only was Company B not artificial, the various expenses queried by the Revenue were also not artificial. The various transactions queried were actual transactions, Company B was legally liable to pay such expenses. The expenses have been audited. They cannot be artificial because the Revenue thinks that they are artificial.
- c. In the submission before the Board, the present representative of the Taxpayer did not go into detail on the disallowed expense items except to comment on the following items: rent, rates and management charges, directors' remuneration, salaries and professional fees. The comments were that these items were arbitrarily disallowed by the Revenue, these expenses are normal expenses which are allowed deductible expenses for companies and that if the expenses are allowed to Company B, then they should be allowed to the Taxpayer under section 16 of the IRO. Company D and the present representative had written to the Revenue previously on the disallowed expenses by letters dated 10 July 1998 and 1 April 1999 respectively. It is useful to summarize the explanations given in these two letters in point form hereinafter appearing (Note that (a) sets out the

INLAND REVENUE BOARD OF REVIEW DECISIONS

explanation in Company D's letter dated 10 July 1998 and (b) sets out the explanation in the present representative's letter dated 1 April 1999):

- i. Rent, rates and management fees
 - (a) Quarters expenses of directors of Company B. The Taxpayer works frequently from home premises. The study plays significant part in assessable profits (see paragraph 2(m)(i) above).
 - (b) Lease in Company B's name. The Service Agreement provides that it is responsible for providing the premises to the Taxpayer.
- ii. Travelling expenses
 - (a) Directors' annual holidays and travelling expenses in capacity of company employees.
 - (b) Travel in connection with company business. The Service Agreement states that Company B is responsible.
- iii. Directors' remuneration
 - (a) Employment agreement cannot be located.
 - (b) Paid to directors for services rendered for and on behalf of the company. Normal expense of any limited liability company.
- iv. Salaries
 - (a) Would have been included with the directors' remuneration in the employment agreement. Evidence of payment part of audit procedure.
 - (b) Normal and necessary expense required for company to do business. Necessarily required in the operation of the business. Referred to in the Service Agreement. No details of who the directors' remuneration and salaries were paid to as records are in a godown.
- v. Medical expenses
 - (a) [Not included in the letter].

INLAND REVENUE BOARD OF REVIEW DECISIONS

- (b) Incurred in keeping the consultant in a healthy manner in order that the functions required of him can be carried out.
- vi. Electricity, water and gas
 - (a) Expended on behalf of directors' quarters (viz, the Taxpayer's residence).
 - (b) Required to be paid by Company B under the Service Agreement.
- vii. Professional fees
 - (a) [Not included in the letter].
 - (b) [Not included in the letter].
- viii. Boat expenses
 - (a) In Company B's name and verified by audit.
 - (b) [Not included in the letter].
- ix. Audit Fee
 - (a) [Not included in the letter].
 - (b) Every limited company must be audited.

Note 1: The present representative's letter dated 1 April 1999 stated the similar arguments which were argued in this appeal in respect of all the expenses as follows:

'Also certain other expenses have been disallowed in whole or in part. All of the expenses which were deducted are necessarily incurred in the production of the company's income. These amounts have been determined by amounts paid by the company from its own bank account. As such they are liabilities of the company which must be paid by the company if it is to survive. All of the expenses which we have provided details for have been audited by independent certified public accountants. These expenses have been verified as correct expenses of the company and therefore

INLAND REVENUE BOARD OF REVIEW DECISIONS

should not be the subject of any question as to why they are expenses of the company.'

Note 2: The present representative's letter dated 1 April 1999 also enclosed with this letter a tenancy agreement between Company B and the landlord in respect of the residence of the Taxpayer, sample utility bills and sample invoices supporting travelling expenses, medical expenses, entertainment expenses and professional fees.

- d. The Practice Note 24 has changed the law. Previously, Company B companies have been used by most professionals and allowed for tax purpose. Practice Note 24 was promulgated to seal up loopholes in the legislation. Practice Note 24 cannot alter the law. In implementing Practice Note 24, the Revenue is seeking to implement its own policy and not the law.

Revenue's case

10. The Revenue's submissions are summarized as follows:
 - a. Sections 16 and 17 of the IRO provide an exhaustive list of tax deductible or prohibited expenses.
 - b. Section 61 prevents the use of artificial or fictitious device to gain a tax advantage. A commercially unrealistic transaction is an artificial transaction.
 - c. The management agreement was an artificial device with the predominant purpose of disguising non-deductible expense. The Taxpayer and his wife are related to Company B. The actual fee earning work was done by the Taxpayer. There was no commercial justification for the interposition of Company B and the Taxpayer other than for a tax benefit.
 - d. Submission on why each of the disallowed expenses of Company B were disallowed were given. Basically, the reasons for disallowing such expenses were that some were private or domestic in nature, some were tax driven, some were not related to the fees earned by the Taxpayer and no details were given by the Taxpayer in respect of the others. The Revenue pointed to the private nature of some of the expenses in which supporting documents were submitted in the said letter dated 1 April 1999 from the present representative to the Revenue.
 - e. The Revenue invited the Board to review even some of the allowed expenses (notably the entertainment expenses) in the light of the

INLAND REVENUE BOARD OF REVIEW DECISIONS

documents relating to expenses submitted to the Revenue by the Taxpayer in his present representative's said letter dated 1 April 1999. The Revenue's view was that the documents did not support the view that the entertainment expenses were related to the production of the Taxpayer's chargeable profit.

- f. In support of the Revenue case, the following cases were cited:
- i. Wharf Properties Ltd v CIR, Privy Council Appeal No 40 of 1996, HKLR 1997, 252.
 - ii. CIR v Douglas Howe, 1 HKTC 939.
 - iii. D61/91, IRBRD, vol 6, 457.
 - iv. D32/93, IRBRD, vol 8, 261.
 - v. D32/94, IRBRD, vol 9, 97.
 - vi. D110/98, IRBRD, vol 13, 553.
 - vii. Handley v Federal Commissioner of Taxation, 11 ATR 644.
 - viii. Littlewoods Mail Order Stores Ltd v IRC [1969] WLR 1241.
 - ix. D44/92, IRBRD, vol 7, 324.

The issues

11. The issues to be decided are:
- a. Whether and how section 61 applies in the present case.
 - b. Irrespective of whether section 61 applies or not, whether the assessor and the Commissioner's determination was correct in disallowing the various disallowed expenses categories in the profit and loss account of Company B (see the Table of Expenses annexed hereto).

Practice Note 24

12. We would like to deal with the contention of the Taxpayer that Practice Note 24 changed the law as a preliminary matter. It is clear that the Commissioner has no authority or jurisdiction to change the law through Practice Note 24. If Practice Note 24 seeks to change the law and the Revenue purports to implement this Practice Note 24, the Taxpayer

INLAND REVENUE BOARD OF REVIEW DECISIONS

has good cause to complain and succeed in this appeal since it is the application of Practice Note 24 by the assessor in the present case which gave rise to this appeal.

13. Practice Note 24 itself regarded that no change in legislation was required. Practice Note 24 deals with Type II service company arrangements which *‘typically involve deductions being claimed by an unincorporated business for payments, often described as management fees, which are made to a company or a trust (‘Service Company’) controlled by the proprietor or partners of the business’*; (from paragraph 1 of Practice Note 24). The use of Company B by the Taxpayer in this present case is a Type II service company arrangement. Paragraph 3 of the Practice Note stated that: *‘legislation would not be required. Rather, the Department should seek to discourage abuse by both explaining in a Practice Note the circumstances under which service company claims will be challenged and by placing greater reliance on the general anti-avoidance provisions of the Ordinance. Accordingly, the purpose of this Practice Note is to set out the Department’s position in relation to the application of the present terms of the law to Type II arrangements.’*

14. Practice Note 24 was the result of the Financial Secretary’s crackdown on service company arrangements in 1995. It seeks to clarify the legal basis under which the Revenue would challenge Type II service company arrangements which are not operated on a proper commercial basis. Several legal bases were set out:

- (i) The first was to dissect the management fees paid and that which is not attributable to the production of chargeable profits disallowed under section 16(1). D61/91 was cited to support this. This approach was adopted by the assessor in this appeal.
- (ii) Where the management fee was incapable of being split into its component parts, it would be disallowed in total. It is for the Taxpayer to prove that the money had been used in the production of chargeable profits. D32/94, IRBRD, vol 9, 97 and D96/98, IRBRD, vol 6, 372 were cited to support this.
- (iii) Section 61 allows an assessor to disregard artificial or fictitious transactions. This approach was also used in this appeal by the Revenue in addition to the dissection of the management fees above mentioned.
- (iv) Section 61A allows the Revenue to disregard or take steps to counteract any transaction which has the sole or dominant purpose of conferring a tax benefit.

15. The Revenue has not applied section 61A in the present case and its application is not dealt with in this appeal.

16. In our views, Practice Note 24 did not change the law. We do not accept that by seeking to apply Practice Note 24, the Revenue is seeking to impose a new ‘law’. Practice

INLAND REVENUE BOARD OF REVIEW DECISIONS

Note was a warning that Type II service company arrangements will be scrutinized by the Revenue and sets out the legal weaponry at its disposal to attack such arrangements.

Lifting the corporate veil

17. Another preliminary point which we would like to address is the question of lifting of the corporate veil. We accept the concept of separate legal identities for corporations. This is a corner stone of our laws and we need not be persuaded otherwise. We also accept without reservation the following passages quoted by the Taxpayer's present representative: '*A taxpayer is entitled to take advantage of whatever benefits he can obtain from the Inland Revenue Ordinance;*' D61/91, IRBRD, vol 6, 457 at 471 and '*Every man is entitled if he can order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be*'; The Commissioner of Inland Revenue v The Duke of Westminster [1936] AC 1 at 19. However, there are exceptional situations where the corporate veil available to Company B is lifted by section 61 or by the dissection of the management fees under section 16.

18. We have no hesitation to say that the corporate veil can be lifted for the purpose of section 61. In each of the Board of Review cases cited to us where a service company arrangement arises and in CIR v Douglas Howe, 1 HKTC 936 and Littlewoods Mail Order Stores Ltd v IRC [1969] 1 WLR 1241, the Board of Review and courts have lifted the corporate veil and had not decided the issues based on whether corporate veil could be lifted. It is only in exceptional circumstances that the corporate veil can be lifted. Section 61 of the IRO is one of those exceptional circumstances.

Artificial or fictitious transaction

19. Whether section 61 applies to service company arrangement in this appeal depends on whether any artificial or fictitious transaction exists.

20. D61/91, IRBRD, vol 6, 457 and D32/93, IRBRD, vol 8, 261 cited by the Revenue did not deal with section 61 and the question of artificial or fictitious transaction. Nor did Case D32/94, IRBRD, vol 9, 97 in which the taxpayer, a medical practitioner, admitted that section 61 applied to his case in order to avoid the dire consequence of the board disallowing the management fee in total as the Board was of the view that on the evidence of that case the management fee was indivisible. Although the Board in D110/98, IRBRD, vol 13, 553 cited to us mentioned on the side that the wording of section 61 does not allow the Revenue to disregard a part of a transaction, we are of the view that if service company arrangement is to be disregarded in accordance with section 61, then it is open to the Revenue to assess the chargeable profits of a taxpayer by totally ignoring service company and the service fees. With service company and service company arrangement out of the way (in other words, after lifting the corporate veil), it is open to the Revenue to dissect the outgoing expenses of service company as if such outgoing or expenses were that of a taxpayer in the light of whether such outgoing or expenses were deductible to the extent to which they are incurred in the production of a taxpayer's chargeable profits.

INLAND REVENUE BOARD OF REVIEW DECISIONS

21. We bear in mind that a properly and commercially structured service company arrangement is neither artificial nor fictitious. If the Taxpayer can satisfy the Board that nature of the services provided by Company B were genuine and commercially realistic and that the payment of the service fee by the Taxpayer was for the services provided by Company B, there is no reason whatsoever that section 61 should apply.

22. There is nothing artificial or fictitious about the existence of Company B. The Service Agreement itself was not fictitious. It exists and is legally enforceable. What we need to decide is whether service company arrangement, the *raison d'être* of the Service Agreement, is artificial or fictitious. We do not think that service company arrangement is fictitious as this arrangement exists. However, having considered the facts, the documents and submissions submitted, we conclude that the transaction, viz, service company scheme or operation underlying the Service Agreement and Company B, is artificial and commercially unrealistic. The combination of the following factors persuaded us to this conclusion:

- a. The shareholders and directors of Company B were the Taxpayer and his wife. There were no other shareholders or directors. This fact, as with the other facts or factors hereinafter appearing, is not of itself conclusive. It only goes to the point that the people involved were connected and related and thus could enter into commercially unrealistic transactions between them.
- b. Company B had no other clients; the sole source of income being the service fees paid by the Taxpayer.
- c. There is no evidence on what were the actual services provided by Company B. We know only what service Company B was contractually obliged to provide under the Service Agreement and we could only speculate on what were the actual services. The services to be provided contractually were extensive. Clause 2 of the Service Agreement sets out the extent of the services.

'(2) Company B shall as of and as from the first day of January, Nineteen Ninety-one:

- (a) provide or procure the provision of such consultancy, technical, managerial, organizational, administrative, financial and other services, functions and assistances to the Taxpayer in Hong Kong as the Taxpayer may from time to time reasonably require.*
- (b) engage all necessary employees including, without limitation all professional, administrative, secretarial and*

INLAND REVENUE BOARD OF REVIEW DECISIONS

service staff, consultants, contractors, agents, sub-agents, brokers and others whose services are necessary or requisite for the carrying on of the Taxpayer's business.

- (c) *provide all necessary offices, office plant, machinery, furniture and equipment together with other premises and fixtures, fittings and equipment including, without limitation, domestic accommodation for employees engaged pursuant to Clause 2(b) hereof.*
- (d) *purchase or otherwise procure all foods, supplies and services necessary for the Taxpayer's business including without limitation, the provision of motor vehicles, law library, legal wearing apparel, telephones, telex machines, stationery, postage and advertising.*
- (e) *be responsible for all expenses incurred with or relating to entertainment and travelling necessary for the Taxpayer's business.*
- (f) *be responsible for the management, letting, cleaning, repair and insurance of all land, buildings, furniture and fittings owned or leased by the Taxpayer together with the provisions and cost of services and utilities to the said buildings including, without limitation, rates, management fees, water, gas and electricity. (hereinafter together referred to as "the Services").'*

The Services to be provided are looked at in the light of the Taxpayer's business which was that of a practising barrister. Clauses 2(b) to (e) specifically stated that the services described in these sub-clauses are to be related to the Taxpayer's business. The services in Clause 2(a) need not be related to the Taxpayer's business and hence more general and extensive and further such services are to be provided as the Taxpayer 'may from time to time reasonably required'. There is no evidence of whether any service under Clause 2(a) was ever required or rendered. We do not know whether the Taxpayer had required service under Clause 2(a) and how services under Clause 2(a) differs from that of the services required for the Taxpayer's business. The services in Clause 2(f) also need not relate to the Taxpayer's business. They relate to property management service to properties owned or leased by the Taxpayer. It is not clear if any service under this Clause 2(f) was provided since the lease to the Taxpayer's home appears to have been leased by Company B and the written replies and submission

INLAND REVENUE BOARD OF REVIEW DECISIONS

of the Taxpayer's representative suggest that the Taxpayer's home was provided as director's quarters under Clauses 2(b) and (c) of the Service Agreement.

The Service Agreement attempted to include all and any possible service. This blanket approach serves to illuminate the artificiality of service company arrangement. It is not commercially real. Had the services been more specific or confined to support services related to the Taxpayer's business as a practising barrister, and assuming there were no other adverse factors, service company arrangement would have been commercially real.

- d. Another factor which led us to conclude that this particular service company arrangement is artificial comes from our analysis of the expenses of Company B. This analysis is similar to, but not the same as, the dissection of the management fee. This analysis could not be done in detail or with any great accuracy given the paucity of the evidence presented to us. There were little evidence or explanation on the disallowed expenses to show how and why the disallowed expenses are reimbursable under the Service Agreement. The bills and invoices produced to the Revenue to support the travelling expenses, medical expenses and entertainment expenses could not be said to be reimburseable as expenses and outgoings suffered or incurred in connection with the services as mentioned in Clause 3 of the Service Agreement. Further, without further evidence from the Taxpayer, we are of the view that the boat expenses and those items of expenditure in which bills and invoices were produced (relating to restaurants, resort hotel, package tours, air fares and medical fees) were personal and private in nature. The rent, rates, management fees and utility charges may well relate to the services defined in Clauses 2(b) and (c) of the Service Agreement (which includes the provision of domestic accommodation for employees). However, the Taxpayer did not make clear who the employees are or their functions. Company D's explanation to the Revenue in its letter dated 10 July 1998 suggests that the directors were the employees. But the present representative submitted that the function of the employee was record keeping and filing. For the above reasons, our analysis of the disallowed expenses leads us to conclude that the disallowed expenses were domestic or private in nature and did not relate to the services contemplated under the Service Agreement. There was no commercial justification for Company B to charge the Taxpayer for these expenses. Unrelated parties would not have allowed Company B to pay for these expenses. Even if the service arrangement under the Service Agreement were commercially real, the actual performance and implementation of the arrangement was flawed.

INLAND REVENUE BOARD OF REVIEW DECISIONS

23. We find that the present service company arrangement is artificial. The next question is whether the whole of the service fee paid to Company B by the Taxpayer should be disallowed. Previous Boards have decided similar appeals on the basis that if the dissection of management fee can be done, then the adjustments will be made to analyse the expenses of service company and disallow those expenses not related to a taxpayer's chargeable profit. We undertake this same dissection process for the disallowed expenses:

- a. We have already expressed our views that the boating expenses, the travelling expenses, medical expenses and entertainment expenses as being personal or private in nature and hence not deductible.
- b. No evidence was produced on whom the salaries and directors remuneration were paid and why they were paid. Prima facie, these expenses have not been established by the Taxpayer to relate to the production of his chargeable profits.
- c. The rent, rates and management charges expense item is more difficult. The question is whether these payments relating to the Taxpayer's residence are deductible expenses given Company D's submission '*that the Taxpayer is frequently obliged to work from home premises especially at evenings, weekends and public holidays. One room of his three bedroom flat is fitted out as a study with a desk, law books, telephone/fax, ... etc. and accordingly plays a significant part of the assessable profits produced by our client (Taxpayer).*' Sections 17(a) and (f) operate to disallow domestic or private expenses and rent or expenses in connection with any premises or part of premises not occupied or used for the purpose of producing profits. If the Taxpayer can establish the necessary facts that his study was used primarily and perhaps exclusively for his practice, he would have a good case to claim at least a portion of the total residential expenses duly apportioned to his study. Even with the necessary facts established, the Taxpayer would still have to overcome the view that one does not look at use to which the study is put but at the character of the study. It does not cease to be a part of the Taxpayer home merely because, as a matter of convenience, he uses it on certain times for the purpose of generating his chargeable profit. This was the view adopted in the Australian tax case *Handley v Federal Commissioner of Taxation*, 11 ATR 644 which is not binding on us. We do not have to decide on this as no evidence (other than the aforesaid submission by Company D) was presented to us to consider this issue. The Taxpayer had not discharged his onus under section 64(4) in this regard.
- d. Having decided that service company arrangement for which purpose Company B was set up by the Taxpayer is artificial and section 61 applies, it follows that those expenses which did not relate to the production of the chargeable profits of the Taxpayer should not be allowed as the deductible

INLAND REVENUE BOARD OF REVIEW DECISIONS

expense of the Taxpayer under section 16(1) and section 17 of the IRO. Hence all expenses relating to the upkeep of Company B (the professional and audit fees, the directors' remuneration) were not deductible vis-a-vis the Taxpayer. It also follows the argument that because an expense item was deductible from the chargeable profits of Company B and therefore it is deductible as a chargeable profit of the Taxpayer must fail.

- e. Further, as Company B is to be disregarded under section 61, logically, the mark-up (whether it be the 12.5% usually given by the Revenue or the 5% charged under the Service Agreement) for those deductible expenses conceded by the Revenue should also not be deductible. However, we are not prepared to disturb the concession on the 12.5% mark-up granted by the Revenue to the Taxpayer.

24. Our conclusion that service company arrangement in this appeal is artificial is based on the evidence and the circumstance of this case. It does not mean that all service company arrangements are artificial. It is incumbent on the Board to look at the individual circumstances and evidence of each service company arrangement in any appeal and to reach its own conclusion as to the applicability of section 61.

Section 16 expense dissection

25. Having decided that section 61 applied, this would have disposed of the appeal. However, we would like to set out our views as to the applicability of Revenue's method of dissecting Company B's expenses and disallowing certain expenses as the Taxpayer's expenses if section 61 does not apply. This issue can be expressed in several forms:

- a. Could the corporate veil be lifted if no view of artificiality of service company arrangement is formed? After all, the dissection of the management fee entails the lifting of the corporate veil if the expenses of Company B is to be allowed or disallowed on the basis that it relates to the Taxpayer's chargeable profit (rather than Company B's profit).
- b. Must section 61 be applied first before the aforesaid expense dissection takes place?
- c. What if service company arrangement was not artificial or fictitious, would it still have been opened to the Revenue to dissect service company's expenses?

26. The Board in D61/91 and D32/93 clearly answered 'yes' to the 3 forms of this issue. Both of these cases did not involve section 61. In D32/94, one finds the peculiar situation where the taxpayer admitted that service company was a sham and that section 61 applied. In that case, the tax representative had submitted that the service fee paid was one lump sum and indivisible. That being the case, it would have been opened to the Board to

INLAND REVENUE BOARD OF REVIEW DECISIONS

disallow the service fee in total. The taxpayer then informed the Board that *'he was not seeking to use service company as a means of reducing his otherwise taxable income. He said that he only wished to claim those expenses which would have been deductible if they had been paid by him direct out of his medical practice.'* It was open to the taxpayer to make an alternative submission that the service fee was divisible. Instead, the taxpayer admitted that section 61 applied.

27. It appears to us that it is difficult to apply the management fee dissection without first concluding that service company arrangement was artificial or fictitious. This was what had caused some hesitation to this Board in reaching a conclusion. There must have been some artificiality or fiction involved in service company arrangement which sent warning signals. The interposing entity (viz service company) must be disregarded first. Otherwise, it would not be possible to justify an arbitrary apportionment of service company's expenses and attributed certain of these expenses to that of the Taxpayer's expenses in light of the fact that, insofar as the Taxpayer is concerned, the Taxpayer's expenses was the service fee only. The apportionment provision in Rule 2A(1) of the Inland Revenue Rules could not form the basis of the management fee dissection. Rule 2A(1) of the Inland Revenue Rules allows apportioning expenses incurred in the production of profits inside and outside Hong Kong. No such similar rules exists for the dissection of expenses of service companies in service company arrangements.

28. Where circumstances exist to raise doubts on a service company arrangement, one would further test the commercial reality and genuineness of service company arrangement by looking at the expenses of service company. One may find that service company expenses are private or domestic expenses or are expenses which do not relate to the service provided. This analysis of service company's expenses is, in fact, a dissection of service company's expenses. Hence, in a manner of speaking, one goes through a process or analysis similar to a management fee dissection which combined with other circumstances of the case, will lead one to conclude whether a service company arrangement is artificial or not. If one concludes that the arrangement is artificial, then only those expenses of the now discarded service company which relate to the generation of a taxpayer's chargeable profit (that is the so-called dissection of management fee) are allowed. In other words, the dissection of service company's expenses (akin to the dissection of management fee) is one of the tools used to determine whether an arrangement is artificial or no; if it is artificial, then the Revenue can use the management fee dissection method to apportion the management fee paid to service company and allow only those expenses which generated a taxpayer's chargeable profit. This practice of dissecting management fees irrespective of whether section 61 applies has been applied by the Board and we are not prepared to disturb it. We adopt the view of the Board in D32/94 when it stated that: - *'the approach taken by the Commissioner is practical but perhaps too lenient'*; D32/94, IRBRD, vol 9 at 97 at 107.

29. As for the allowed expenses already conceded by the Revenue, we will not disturb those concessions. In the circumstances, this appeal is dismissed and the determination is confirmed.

INLAND REVENUE BOARD OF REVIEW DECISIONS

Annexure

Table of Expenses

<u>Description in profit/loss account</u>	1994/95		1995/96	
	Amount in profit/loss account	Allowed by assessor	Amount in profit/loss account	Allowed by assessor
<i>(a) Disallowed expenses</i>				
Rent, rates and management charges	460,626	---	571,513	---
Travelling expenses	151,490	---	97,882	---
Directors' remuneration	137,000	---	150,800	---
Salaries	42,000	---	42,000	---
Medical expenses	30,109	---	16,506	---
Electricity, water and gas	12,335	---	11,158	---
Professional fees	19,692	---	14,350	---
Boat expenses	12,000	---	12,000	---
Audit fee	8,200	---	8,600	---
<i>(b) Deductible expenses (allowed in part or in whole)</i>				
Insurances	38,978	38,978	5,920	5,920
Telephone and paging	13,363	13,363	26,682	26,682
Newspapers and periodicals	2,296	2,296	---	---
Entertainment	246,742	246,742	217,401	217,401
Chambers expense	161,000	161,000	180,000	180,000
Motor vehicle expenses	14,189	14,189	17,055	16,445
Sundry expense	9,954	8,114	12,484	12,484
Hire purchase interest	7,281	7,281	---	---
Bank charges	948	948	250	250
Printing, stationery and postages	250	250	1,600	1,600
Depreciation	<u>56,455</u>	<u>40,159</u>	<u>32,833</u>	<u>7,284</u>
<i>Total</i>	1,424,908	533,320	1,419,034	468,066
<i>Add: 12.5 mark-up</i>		<u>66,665</u>		<u>58,508</u>
Total: Allowable management fee		599,985		526,574
Management fee charged		1,496,154		1,489,986
<i>Less: Allowed management fee</i>		<u>599,985</u>		<u>526,574</u>
<i>Management fee adjustment</i>		896,169		963,412