

INLAND REVENUE BOARD OF REVIEW DECISIONS

HCIA 3/2001

**IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE**

INLAND REVENUE APPEAL NO. 3 OF 2001

BETWEEN

CHEUNG WAH KEUNG

Appellant

AND

THE COMMISSIONER OF INLAND REVENUE

Respondent

Coram: Deputy High Court Judge Poon in Court
Dates of Hearing: 2 and 16 November 2001
Date of Judgment: 21 January 2002

J U D G M E N T

1. This is an appeal by way of case stated brought by Mr Cheung Wah Keung ("the Taxpayer") pursuant to section 69 of the Inland Revenue Ordinance, Cap. 112 ("the Ordinance") in respect of the Decision No. D39/00 of the Board of Review ("the Board") dated 6 July 2000. In this judgment, references to statutory provisions are those in the Inland Revenue Ordinance, Cap. 112, unless otherwise stated.

Agreed Facts

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2. At the hearings before the Board, the following facts were agreed.

(1) *Sun Ling, First-Rate and the Taxpayer*

3. Sun Ling Motors Co. Ltd ("Sun Ling") is a motor car dealer. Its shareholders and directors do not have any relationship with both the Taxpayer and one First-Rate Company Limited ("First-Rate"). First-Rate was incorporated on 26 November 1982. The Taxpayer holds 80% of its issued share capital and has been a director since 12 July 1985. For each of the years 1991 to 1995, Sun Ling as principal and First-Rate as manager entered into an annual service contract entitled "Contract for the Manager". These contracts were couched in similar terms. Those relating to these proceedings are summarized below:

- (1) The manager was to provide manpower or resources to provide service for the principal. Any manpower or resources engaged directly or indirectly by the manager shall not constitute any employer and employee relationship or any legal responsibility with the principal. The duty of the manager covered all matters with regard to car dealership and the matters between the principal and its client.
- (2) The Taxpayer was authorized to be fully responsible for, observe and perform the contract. The manager was represented by its sales manager but it was merely to facilitate the manager in representing the principal in dealing in motor vehicle transactions and other matters. It did not constitute employer and employee relationship.
- (3) Service hours were between 9:30 a.m. to 7:00 p.m., Monday to Saturday.
- (4) Monthly service fees were fixed at \$7,000 for the 1991 contract; \$8,500 for the 1992 contract; \$9,000 for the 1993 contract; \$11,000 for the 1994 contract and \$12,300 for the 1995 contract; with commission for motor vehicle transactions calculated according to provisions on commission computation. There was an additional telephone allowance of \$1,000 per month. The principal would at the end of the year give a special remuneration to the manager having regard to the business performance. But the minimum amount of special remuneration shall be at least one month of the service fees.
- (5) Both parties could terminate the contract by giving one month's notice or one month's service fees of the manager. If the notification period was under one month, then the rate shall be computed *pro rata*.
- (6) All labour and medical insurance of persons engaged by the manager shall be paid for the principal.

4. For the years of assessment 1992/93 to 1994/95, Sun Ling paid to First-Rate

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commission in the respective sum of \$451,397, \$495,578 and \$358,155. In the year of assessment 1995/96, the total amount of commission, service fee and allowances paid was \$199,162.

5. First-Rate reported in its financial statements for the years of assessment 1992/93 to 1995/96 that its principal activity was acting as a commission agent. During the five years of assessment 1992/93 to 1996/97, First-Rate reported the following commission income:

Year of Assessment	<u>1992/93</u>	<u>1993/94</u>	<u>1994/95</u>	<u>1995/96</u>	<u>1996/97</u>
	\$	\$	\$	\$	\$
Sun Ling	451,397	495,578	358,156	199,162	-
Set Win Trading Co. Ltd	44,000	-	-	-	-
Kar Wo Electric Work	12,667	-	-	-	-
Auto Trade Centre	30,000	-	-	-	-
England Motors and Trading Ltd	-	-	-	-	63,462
Stuttgart Auto Centre	-	-	-	5,000	-
Miscellaneous	-	-	-	94,530	-
Total as per audited accounts	<u>538,064</u>	<u>495,578</u>	<u>358,156</u>	<u>298,692</u>	<u>63,462</u>

6. The assessable profits/(adjusted loss) before set-off of the loss brought forward as per First-Rate's Profits Tax returns for the years of assessment 1992/93 to 1995/96 were \$15,150, (\$13,666), \$15,197 and (\$61,204) respectively. First-Rate did not have any assessable profits for the years of assessment 1992/93 to 1995/96 after setting off the loss brought forward. The assessor issued computations showing the loss positions of First-Rate for those years as per its returns.

(2) *Salaries assessment*

7. In the Taxpayer's salaries tax return or tax returns – individuals for the years of assessment 1992/93 to 1995/96, his earnings from First-Rate were his only declared income. The assessor raised salaries tax assessments in accordance with the income reported in the tax returns submitted. They were \$400 for the year 1992/93, \$2,470 for the year 1993/94, \$400 for both the years 1994/95 and 1995/96.

8. On 23 March 1999, an Assistant Commissioner raised additional salaries tax assessments for the years of assessment 1992/93 to 1995/96 under section 61A. They were \$82,984, \$86,716, \$67,123 and \$35,632 respectively. It is the view of the Assistant Commissioner that the interposition of First-Rate between Sun Ling and the Taxpayer was a scheme entered into for the sole or dominant purpose of enabling him to obtain a tax benefit. It was a form of disguised employment. As such, the scheme was challengeable by authority of section 61A and the income allegedly received by First-Rate from Sun Ling was treated as the Taxpayer's income from the employment with Sun Ling.

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Determination by the Acting Deputy Commissioner

9. The Taxpayer objected against the additional salaries tax assessments on the grounds that the assessments were excessive, unrealistic and not in accordance with the tax returns previously filed and that the Taxpayer had no relationship or employment with Sun Ling.

10. The Acting Deputy Commissioner did not accept the objection. On 20 August 1999, he issued a determination to the Taxpayer under section 64(4). Further, pursuant to section 64(2), he increased the additional salaries tax assessment for the year of assessment 1994/95 to \$68,503.

Proceedings before the Board

11. On 2 September 1999, Taxpayer appealed against the determination under section 66. The grounds of appeal were that the additional salaries tax assessments were incorrect, excessive and not in accordance with the tax returns previously submitted. Further, none of the income in the additional assessments was accrued to the Taxpayer and he did not receive such income. In addition, both the assessor and the Commissioner failed to identify the transaction to which sections 61 and 61A were applied.

12. The Board identified two main issues for its decision:

- (a) whether section 61 or section 61A was applicable to the interposition of First-Rate between Sun Ling and the Taxpayer; and
- (b) whether the income paid by Sun Ling should be assessed as the Taxpayer's income from employment.

13. The Board made the following additional findings:

- (1) At the material time during the relevant years of assessment (1992-1996), First-Rate had three directors, namely, the Taxpayer, the Taxpayer's son and one Au Yuen Lan. Au resigned in September 1995.
- (2) The Taxpayer's son was born in 1973. He was a student in 1992, wholly maintained by the Taxpayer.
- (3) On the Taxpayer's own admission, First-Rate was controlled and operated by him.
- (4) First-Rate entered into five contracts with Sun Ling according to which First-Rate was to assign the Taxpayer to render services to Sun Ling.
- (5) The five addresses which the Taxpayer gave on his name card with Sun Ling were all Sun Ling's addresses, including showrooms, service centres

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and workshops.

- (6) For services rendered by the Taxpayer, the following payments were made by Sun-Ling to First-Rate:
 - (a) a fixed rate of remuneration;
 - (b) commission based on transactions completed; and
 - (c) special bonus based on the overall performance of Sun Ling.

In addition, Sun Ling agreed to pay for the labour insurance and the medical insurance in respect of the Taxpayer.

- (7) As per his own tax returns, the Taxpayer received director's salaries from First-Rate namely \$95,000.00 for 1992/93, \$90,000.00 for 1993/94, \$92,000.00 for 1994/95 and \$90,000.00 for 1995/96. Although First-Rate reported director's salaries to be \$141,000.00 and \$146,000.00 for 1992/93 and 1993/94 respectively, the balance of \$46,000.00 for 1992/93 and the balance of \$56,000.00 for 1993/94 were salaries purportedly given to the Taxpayer's son. In his evidence, the Taxpayer said he did not know the details of the figures. But the Board found that these salaries were conveniently pitched at \$46,000.00 and \$56,000.00 for the relevant years so that the Taxpayer's son could claim his full personal allowance. These salaries were nothing more than a book entry.
- (8) Except for the director's salaries aforesaid, First-Rate did not pay any wages or salaries, indicating strongly that no one other than the Taxpayer was available from First-Rate to render services to Sun Ling. Further, as one of the conditions of the contracts, First-Rate specially assigned the Taxpayer to render services to Sun Ling.
- (9) The terms of the contracts between Sun Ling and First-Rate pointed to an employer and employee relationship between Sun Ling and the Taxpayer but for the interposition of First-Rate.

14. In the end, the Board dismissed the appeal. In essence, the reasons are:

- (1) Without the interposition of First-Rate, the Taxpayer would not be able to claim as deductions his personal and private expenses. When First-Rate was interposed between Sun Ling and the Taxpayer, the Taxpayer's expenses would be disguised as director's benefits of First-Rate and claimed by First-Rate as deductible and as a result the Taxpayer's ultimate salaries tax liabilities were reduced. There was no commercial reality in the transaction (consisting of the five contracts between Sun Ling and First-Rate and the interposition of First-Rate between Sun Ling and the

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Taxpayer) which was aimed at procuring the services of the Taxpayer to Sun Ling and reducing the Taxpayer's tax liabilities. It was commercially unrealistic and therefore artificial within the meaning of section 61 and should be disregarded. Accordingly, the payments made by Sun Ling to First-Rate should be treated as the Taxpayer's income.

- (2) As to section 61A, the Board drew the inference that the Assistant Commissioner had had regard to the seven elements in section 61A before forming his view. If there should be any doubt about the Assistant Commissioner's compliance with section 61A, the Acting Deputy Commissioner, in his determination, showed clearly that he had duly considered the seven elements before endorsing the view of the Assistant Commissioner. Having examined the seven elements in the light of the circumstances of the present case, the Board also concluded that the transaction was entered into for the sole or dominant purpose of obtaining a tax benefit.
- (3) The Board was not persuaded that the Taxpayer had discharged the burden of proving that the assessments appealed against are incorrect or excessive imposed on him by section 68(4).

Questions of Law Stated

15. The Board stated the following question of law for the court to determine:
 - (a) Did the Board err in law in invoking section 61A when it had concluded that the Taxpayer's transaction, consisting of the five contracts between Sun Ling and First-Rate and the interposition of First-Rate between Sun Ling and the Taxpayer, should be disregarded under section 61?
 - (b) Did the Board err in law in concluding that section 61 and section 61A were both applicable to the Taxpayer's said transaction?
 - (c) Did the Board err in law in concluding on the facts as found by the Board that the Taxpayer's said transaction was artificial or fictitious?
 - (d) Did the Board err in law in concluding on the facts as found by the Board that the Taxpayer's said transaction was entered into or carried out for the sole or dominant purpose of enabling the Taxpayer to obtain a tax benefit?
 - (e) Did the Board err in law in failing to impose on the Commissioner the burden of proving that a case had been made out for invoking section 61 and section 61A?

Appeal

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16. The jurisdiction of the court to consider the questions of law arising on a case stated is governed by section 69. The court may in accordance with its decision on those questions, confirm reduce, increase, or annul the assessment determined by the Board, or may remit the case to the Board with the opinion of the court thereon, whereupon the Board shall revise the assessment as the opinion of the court may require: see sub-section (5).

17. Under section 69(1), the Board's decision is final, subject only to review upon an error of law. In *CIR v Inland Revenue Board of Review and Aspiration Land Investment Ltd* (1988) 2 HKTC 575, Barnett J said at 594 - 595:

"The decision of a Board of Review is like a pyramid. At its base is a number of blocks consisting of primary facts found by the Board upon evidence presented to it. Above these is another line of blocks, consisting of inferences drawn from the primary facts. At the apex of the structure lies the Board's final conclusion based upon the primary facts and inferences.

The final conclusion may be attacked in three principal ways. First, it can be impugned upon the basis that the Board has misdirected itself, for example, upon the burden of proof, or by misinterpretation of a statute. Second, an inference or inferences of the final conclusion may be attacked upon the basis that the primary facts do not admit of an inference drawn from them, or that the primary facts or inferences, or a combination, do not admit of the final conclusion. Third, one or more findings of primary fact may be attacked upon the basis that there was no evidence upon which they could be found. Alternatively, it may be contended that the Board should have made findings of other relevant facts. If the applicant is successful in displacing any of the blocks below the final conclusion or is successful in inserting additional blocks of fact, the structure may be so distorted that the final conclusion must topple and will be set aside by the court."

18. In the present appeal, the Taxpayer does not seek to challenge any findings of facts made by the Board. In essence, Mr Burkett first submitted that the Board erred in applying section 61 and 61A at the same time. He further contended that the Board erred in taking a too restrictive view on what constituted a transaction within the meaning of the two sections and had thereby failed to have regard to the effect of the relationship between the Taxpayer and those parties or companies other than Sun Ling as listed out in the table at paragraph five above. The Board had therefore failed to have regard to all the circumstances surrounding the transaction that it had identified. I will deal with the submissions in turn.

Applying Sections 61 and 61A at the Same Time?

19. Both sections 61 and 61A are anti-avoidance provisions. Their effect, however, is different. Under 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

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artificial or fictitious, he may disregard any such transaction and the person concerned shall be assessable accordingly. In short, the focus of enquiry is whether a transaction is artificial or fictitious. If it is, it may be disregarded, whereupon the person concerned shall be assessable accordingly. Section 61A, on the other hand, applies where any transaction has, or would have had but for this section, the effect of conferring a tax benefit on a person (the relevant person) and having regard to the seven elements listed therein, it would be concluded that the transaction was entered into or carried out for the sole or dominant purpose of enabling the relevant person to obtain a tax benefit. Here, the question is not whether the transaction is artificial or fictitious. What is called in question is its effect, namely, whether it had the sole or dominant purpose of enabling the relevant person to obtain a tax benefit. If it has such an effect, the liability to tax of the relevant person may be assessed as if the transaction or any part thereof had not been entered into or carried out or in such manner as the assistant commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained: see section 61A(2).

20. Mr Burkett argued that when approaching a transaction, one should first consider if section 61 applies. If it does, then the transaction is found to be artificial or fictitious. There is accordingly no transaction to which to apply section 61A as such a transaction would be disregarded. The Board therefore erred in invoking section 61A when it had already concluded that the transaction between Sun Ling and the Taxpayer under section 61 was to be disregarded. The Board erred in applying the two sections together. The Taxpayer in the circumstances did not know the factual basis upon which the additional assessments were made. Given that it was a fundamental error in its approach, the case should be remitted back to the Board with the opinion of the court on the proper approach.

21. Mr Li, Senior Government Counsel for the respondent, conceded that in the present case section 61 is to be applied first and if section 61 is not applicable, then section 61A may be invoked. However, he did not accept that the two sections are mutually exclusive in all circumstances. For the purpose of deciding this appeal, I do not think it is necessary for me to rule one way or the other if the two sections are mutually exclusive. In my view, the question is whether the Board did in fact apply the two sections at the same time in the way as suggested by Mr Burkett. Mr Li contended that the Board did not apply the two sections at the same time. Rather, it applied them alternatively to uphold the additional assessments. I must confess that I was initially attracted by Mr Burkett's submissions. However, after careful consideration, I come to a different view. I will explain why below.

22. There is little doubt that the Board had correctly stated the issue was whether section 61 or section 61A applied. They were put on an alternative basis. The Board then proceeded to examine the materials before it and dealt with the applicability of section 61 and then section 61A separately. It first held that the transaction was artificial within the meaning of section 61 in that it was commercially unrealistic and should be disregarded. The payments by Sun Ling to First-Rate should be treated as the Taxpayer's income and assessed accordingly. The Board went on further to consider the seven

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elements under section 61A and held that the transaction was entered into for the sole or dominant purpose of obtaining a tax benefit. Contrary to Mr Burkett's submissions, the Board's reasoning, when considered carefully, clearly shows that it did not seek to apply the two sections at the same time by first disregarding the transaction under section 61 and then applying section 61A to it. The confusion arose perhaps because the Board had unfortunately failed to state clearly that it approached the matter in two alternative stages: first to consider if section 61 applied; and secondly to consider whether section 61A applied in the event that section 61 did not. The Board's reasoning had also demonstrated clearly the factual basis upon which the additional assessments either under section 61 or section 61A were made. I therefore reject the argument that the factual basis for additional assessments was not made known or clear to the Taxpayer in the circumstances.

23. With the above in mind, I now come back to the first question of law stated. To recap, the question is whether the Board erred in law in invoking section 61A when it had concluded that the transaction in question should be disregarded under section 61. In my view, it was not necessary for the Board to invoke section 61A in the present case when it had concluded that the transaction should be disregarded under section 61. The Board could uphold the additional assessments under section 61 alone. Although the Board had not made it abundantly clear that it applied the two sections alternatively, the failure is not fatal. As I have sought to demonstrate above, the Board did not apply the two sections at the same time in the way as suggested by Mr Burkett. Rather, it applied the two sections separately. In the circumstances, despite the persuasiveness of Mr Burkett's arguments, my answer to this question is "no".

24. The second question is whether the Board erred in concluding that section 61 and section 61A were both applicable to the transaction. On a first glance and given Mr Li's concession on how to apply the two sections, the answer appears to be yes. However, this question must be understood in context. As I have already pointed out, the Board applied the two sections separately and came to the conclusion that it did. This in itself is not objectionable. Understood in that light, the question should be answered with a "no" as well.

Transaction Too Restrictive?

25. I now turn to the third and fourth questions of law stated. They relate to the transaction identified by the Board as consisting of the five contracts between Sun Ling and First-Rate and the interposition of First-Rate between Sun Ling and the Taxpayer. Mr Burkett's submission can be found at paragraph 18 above and are not repeated here.

26. "Transaction" is not defined in section 61. Under section 61A, it is defined as to include a transaction, operation or scheme whether or not such transaction, operation or scheme is enforceable, or intended to be enforceable, by legal proceedings: see sub-section (3). It is common ground that the whole of a transaction and all the circumstances surrounding it ought to be taken into account.

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27. Under section 68(4), the onus of proving to the Board's satisfaction that the assessment appealed against is excessive or incorrect shall be on the Taxpayer. Before the Board, the Taxpayer was represented by the tax representative, Messrs Stanley So & Co. But the points concerning the transaction, now advanced by Mr Burkett, were not raised before the Board. In my view, the onus lied on the Taxpayer to raise these points and to adduce evidence before the Board the nature of other relationships First-Rate or the Taxpayer might have with other companies to make good these points: see *CIR v The Board of Review, ex parte Herald International Ltd* [1964] HKLR 224 at 237. Having failed to do so, the Taxpayer is not entitled now to say that the Board had failed to take into account those relationships. In the absence of any challenge on the findings relating to the transaction that the Board had identified, its conclusion that the transaction was either artificial or fictitious and should be disregarded under section 61 or entered into or carried out for the sole or dominant purpose of enabling the Taxpayer to obtain a tax benefit under section 61A cannot be flawed.

28. Accordingly, I will answer both the third and fourth questions with a "no".

Burden of Proof

29. The last question of law stated relates to the burden of proof. Mr Burkett relied on the Singaporean case of *CEC v. Comptroller of Income Tax* (1950-1985) MSTC 551. There the taxpayer had made out a prima facie case showing among other things that everything was above board and genuine. In such circumstances, the court said that the onus of proving a shame was on the Comptroller. However, at 555 of the judgment, the court made it abundantly clear that the burden of proof throughout until the end of the Comptroller's case rested on the taxpayer to show that the tax is excessive. I do not find this case of particular assistance to the Taxpayer. The burden of proving that the additional salary assessments were excessive or incorrect shall be on the Taxpayer: section 68(4). The burden rests with the Taxpayer to prove that the Commissioner was wrong. Accordingly, I would also answer the last question with a "no".

Conclusion

30. In the course of submissions, Mr Li sought to raise a further question of law for my determination, namely, if the court is of the opinion that the Board did err in law:

- (a) in purporting to apply sections 61 and 61A to the transaction at the same time; and
- (b) in holding that section 61 applies to the transaction, whether upon the facts found by the Board, section 61A applies to the transaction.

In light of my answers to the five questions of law stated by the Board, it is not necessary for me to address this question any further.

31. For the foregoing reasons, this appeal fails in its entirety and I dismiss it

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accordingly with costs.

(J. Poon)
Deputy High Court Judge

Representation:

Mr Francis Burkett instructed by Messrs Knight & Ho, for the Appellant

Mr Herbert Li, SGC instructed by Department of Justice, for the Respondent