

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D5/91

Profits tax - membership of trade association - whether membership fee can be deducted.

Panel: William Turnbull (chairman), Winston Lo Yau Lai and Cheung Wai Hing.

Dates of hearing: 5 and 7 February 1991.

Date of decision: 19 April 1991.

The taxpayer was a private limited company which claimed as an expense a sum of \$60,000 which it was claimed had been paid to a trade association as a membership fee. The sum was divided into \$20,000 being a life membership fee and \$40,000 being a payment to the association to assist the association in purchasing premises for its use. The assessor accepted the submission by the taxpayer but allowed only the sum of \$20,000 as the membership fee and declined to accept the deduction of the \$40,000 additional payment on the ground that it was in the nature of a capital payment to be used by the association to acquire premises for the use of the association. The taxpayer appealed to the Board of Review. At the hearing of the appeal documentary evidence was filed which was accepted by the Board to the effect that the total sum of \$60,000 was a life membership fee. It was further stated by the Commissioner's representative that by way of concession the Inland Revenue Department permits the deduction of membership fees to trade associations including life membership fees.

Held:

The Deputy Commissioner was incorrect in determining whether or not a payment was capital or income by looking at the use to which the recipient of the money put it. The question to be decided is whether or not the payment made by a taxpayer is of a capital or income nature so far as the taxpayer is concerned and not so far as the recipient is concerned. In the present case the payment was a lump sum for a life membership of the association which represented an asset of the taxpayer and accordingly was of a capital nature and not of an income nature. Accordingly the amount of \$60,000 would not be a permissible deduction.

However in the present case the Commissioner had allowed the sum of \$20,000 to be deducted by way of extra-statutory concession. The Board in dismissing the appeal confirmed the assessment and did not seek to disallow the extra-statutory concession which had been granted by the assessor but pointed out that if the Commissioner at the hearing of the appeal had not conceded this then they would have been obliged to increase the amount of the assessment.

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Appeal dismissed.

Cases referred to:

Lochgelly Iron & Coal Co Ltd v Crawford [1913] 6 TC 267
Grahamston Iron Co v Crawford [1915] 7 TC 25
The Adam Steamship Co Ltd v Matheson [1920] 12 TC 399
The Thomas Merthyr Colliery Co Ltd v Davis [1932] 17 TC 519
Joseph Adamson & Co v Collins [1937] 21 TC 400
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So Chau Chuen for the Commissioner of Inland Revenue.
Mak Hing Cheung of Mak Hing Cheung & Co for the taxpayer.

Decision:

This is an appeal by a private limited company against a profits tax assessment raised on it for the year of assessment 1986/87 in which the assessor refused to allow a donation or membership subscription paid by the company to a trade association. The facts are as follows:

1. The Taxpayer is a private limited company which carried on business in Hong Kong.
2. In respect of the year of assessment 1984/85, the Taxpayer claimed as an expense in the computation of its loss for profits tax purposes a sum of \$60,000 which it had paid to a trade association and which it claimed was a membership fee. The assessor rejected the claim by the Taxpayer to include as a deduction in the calculation of the carry forward loss of the Taxpayer the payment of \$60,000. The representatives for the Taxpayer submitted to the assessor that \$20,000 of the total \$60,000 comprised a life membership and \$40,000 was a payment to the association to assist the association in purchasing premises for the association. The assessor accepted this submission and decided to allow the sum of \$20,000 but declined to accept the payment of \$40,000 on the ground that the payment made by the Taxpayer to the association was in nature a capital payment because it was to be used by the association to acquire premises for the association.
3. The matter did not come up for determination by the Deputy Commissioner until the year of assessment 1986/87 because it was only then that the Taxpayer had assessable profits against which the claimed expense could be deducted as a carry forward loss. Following objection by the Taxpayer the Deputy Commissioner decided the matter in favour of the assessor and decided that by concession \$20,000 out of the \$60,000 was allowable as a deductible expense because it represented a contribution to the association in respect of a life

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honourable presidency membership which belonged to the Taxpayer. However so far as the balance of \$40,000 was concerned, the Deputy Commissioner decided that the assessor was correct and that the payment made by the Taxpayer to the association to enable the association to acquire premises for itself was by nature a capital payment and was not capable of being deducted from the assessable profits of the Taxpayer.

4. The Taxpayer then duly appealed to this Board of Review against the determination of the Deputy Commissioner.

At the hearing of the appeal, no witnesses were called to give evidence but a number of documents were tabled before the Board and reference was made to documents attached to the Deputy Commissioner's determination. It appeared from the submissions made on behalf of the Taxpayer and the Commissioner that there was a disagreement with regard to the nature of the payment made by the Taxpayer to the association. In view of this, it is appropriate that we should at the outset place on record our findings and reasons with regard thereto.

According to a contemporaneous receipt in Chinese bearing the date 8 November 1984, the association acknowledged receipt of the sum of \$60,000 being 'membership fee' paid to it by the Taxpayer. As this is a contemporaneous record which speaks for itself, we accept the same as being true and correct. The articles of association of the trade association stated that a person, which included corporations, who donated not less than \$20,000 could be awarded the title of life honourable president and would be exempted from payment of annual subscriptions. A copy of a membership certificate was produced stating that the Taxpayer had been appointed as the life honourable president of the trade association and bore the date of 28 February 1985. A copy of the audited accounts of the association for the period in question were produced before the Board and evidenced that the association had received during that period donations totally \$16,550 and members' funds of in excess of \$500,000. No explanation was given in the audited accounts as to how the association accounted for the membership fee of \$60,000 which was received from the Taxpayer but it was clear that it was included in one or both of the two figures to which we have made reference. There would appear to have been no reason why the association should have split the sum of \$60,000 into different amounts and accordingly we assume that it was all included in the members' funds. Indeed, even if we accept, as was claimed by the representative for the Taxpayer that the sum comprised \$20,000 and \$40,000 being membership fee and donation to the fund for acquisition of permanent association premises, the sum of \$20,000 would have exceeded the sum appearing in the audited accounts of \$16,550, so we are left to draw the conclusion which we do that the entire sum of \$60,000 was credited direct to the members' funds being the amount raised from members during the period in question. This would also accord with the receipt issued by the association stating that the total amount was a membership fee. It also accords with the articles of association of the trade association which provide for a sum of not less than \$20,000 as entitling a person to a life honourable presidency.

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According to the submission made by the representative for the Taxpayer, when the assessor declined to allow the sum of \$60,000 as part of the carry forward loss of the Taxpayer, the association issued to the Taxpayer a letter bearing the date 9 November 1984 stating that \$20,000 out of the \$60,000 was in respect of life honourable president membership fee and the balance of \$40,000 was a donation to the fund for the acquisition of permanent premises for the trade association. The representative of the Taxpayer indicated that though this letter bore the date 9 November 1984 it was not a contemporaneous record but was produced subsequently as evidence to show the purpose for which the association had used the sum of \$60,000. By letter dated 24 September 1990 and which was sent to the Commissioner and which formed part of the determination of the Deputy Commissioner, the representative for the Taxpayer informed the Commissioner as follows:

'A donation of not less than \$20,000 and is exempted from annual subscriptions. The Taxpayer made a donation of \$60,000 (\$20,000 for life membership and \$40,000 for acquisition of association premises). His donation of \$60,000 is for the life honourable president membership.'

Based on the foregoing evidence and having heard the submissions of the parties, we find as a fact that the sum of \$60,000 was paid by the Taxpayer to the association on or before 8 November 1984 and was a membership fee. We further find as a fact that this payment entitled the Taxpayer to be appointed a life honourable president of the association and that the Taxpayer was so appointed on or before 28 February 1985 being the date of the relevant membership certificate. We find as a further fact that the association used the funds which it received from its members partly to pay its expenses and partly to purchase premises for its own use. On the evidence before us we are unable to decide how much of the \$60,000 was used for payment of expenses nor how much was used for acquisition of premises nor how much, if any, was carried forward in cash for the future use of the trade association. As however the assessor and the Deputy Commissioner in his determination appear to have accepted that \$40,000 out of the \$60,000 was used for the purchase of premises and as that was the submission made by the representative for the Taxpayer, we accept for the purposes of this appeal that the \$60,000 membership fee paid to the trade association was used as to \$40,000 in respect of purchase of premises and as to the remaining \$20,000 for other purposes of the trade association. However, we repeat that we have found as a fact that the entire \$60,000 was a membership fee paid by the Taxpayer to the trade association and in return for that membership fee the Taxpayer was made a life honourable president of the trade association and thereafter did not have to pay any annual membership payments.

At the hearing of the appeal, the representative for the Taxpayer appeared and submitted that payments by taxpayers to trade associations were in general deductible against taxable profits because it was desirable that the Taxpayer should join the trade association for the purposes of its business and the membership of the association assisted the Taxpayer in making its taxable profits.

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The representative for the Commissioner submitted that the amount of \$40,000 was not deductible because it was a capital receipt in the hands of the trade association. He said that he did not dispute that payments made to trade associations for the general purposes of the trade associations were capable of deduction against the taxable profits of the members of the trade associations. However, he pointed out that where a trade association raised funds for capital purposes payments made by members to the capital fund of the trade association were not by nature income expenses of the members but were capital payments. In support of his argument, he referred us to the following cases:

Lochgelly Iron & Coal Co Ltd v Crawford [1913] 6 TC 267

Grahamston Iron Co v Crawford [1915] 7 TC 25

The Adam Steamship Co Ltd v Matheson [1920] 12 TC 399

The Thomas Merthyr Colliery Co Ltd v Davis [1932] 17 TC 519

Joseph Adamson & Co v Collins [1937] 21 TC 400

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We were also referred by the representatives of the parties to a circular letter dated 28 February 1967 issued by the Commissioner of Inland Revenue referring to a departmental directive which had been issued relating to subscriptions to trade associations. This stated that 'where the object and activities of a trade association are such that its expenditure, if incurred by an individual trader, would be an expense incurred in the production of profits chargeable to tax, annual subscriptions may be allowed as a deduction. Where the rules provide for the payment of a lump sum for life or permanent membership or in commutation of annual subscriptions, the full amount may be allowed as a deduction, provided no part of the payment is designed to meet special capital expenditure by the association such as the cost of construction of a building. This is by way of an extra-statutory concession'.

The representative for the Commissioner explained that this was a concession by the Commissioner and was the basis on which the sum of \$20,000 had been permitted as a deduction by the assessor.

This case raises a very interesting point but also a very simple point. With the exception of the Commonwealth Taxation Board of Review case, all of the other cases cited to us were United Kingdom decisions. They date back to the 1930's and earlier. We do not know the history or circumstances surrounding those decisions nor are we conversant with the relevant tax law of the United Kingdom. However we must confess to finding some considerable difficulty in understanding the cases if they are to be applied in Hong Kong as part of the interpretation and application of our own Inland Revenue Ordinance. It would appear from the cases and the submissions made by the representative for the Commissioner that if the cases are accepted as

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binding in Hong Kong, it would be necessary in each case to investigate the affairs of the trade association to ascertain how the association spent the moneys which it received from its members. If the trade association spent the moneys received from its members on capital expenditure of the trade association, then the receipts from members could not be deducted against the profits of individual members subject to profits tax. If on the other hand, the moneys received from members were spent by the trade association for its general purposes and as part of its recurrent expenses, then they would be deductible against the profits of its individual members. We pointed out to the representative for the Commissioner that such a rule would be totally unworkable. For example, if a trade association were to purchase a typewriter this would clearly be the acquisition of a capital asset. However a typewriter might be an insignificant acquisition by the trade association and form a minute part of its overall expenses. However, if the rule were to be strictly applied part of the annual subscriptions of members paid to such a trade association would have to be disallowed for profits tax purposes. We cannot believe that this was what the legislators in Hong Kong intended and we do not believe that it is the true meaning of the words of the Inland Revenue Ordinance. For reasons unknown to us, it would appear that in the United Kingdom the Inspector of Taxes sought to investigate the affairs of trade associations and to seek to disallow contributions to the funds of trade associations if the associations used the funds for capital purposes. Apparently, the courts in the United Kingdom supported the Inspector of Taxes in his endeavours. It would appear to us to be a clear breach of the corporate veil to embark upon such a course of conduct. We do not see how a payment made by one taxpayer to another taxpayer can have its nature changed from being an income expense to being capital expense dependent upon the use to which the recipient sees fit to apply the moneys. The United Kingdom cases tended to relate to major capital projects which otherwise would have had to be incurred by the individual taxpayers and that is perhaps why they were decided the way that they were.

Our Inland Revenue Ordinance states that a person who makes profits in Hong Kong must pay tax on those profits. Section 16(1) of our Ordinance states that expenses incurred by a person in earning that taxable income can be deducted for taxation purposes. What we must do is to apply section 16(1) to the facts before us. The question is simple. The Taxpayer made a payment of \$60,000 to the trade association and claims that the payment was to enable it to earn its taxable profits. What we must decide is whether this claim is correct. With due respect to the Taxpayer's representative, we are unable to agree with his submission on the facts and evidence before us. We have no information before us with regard to the trade association nor the manner in which it assisted the Taxpayer to earn any of the profits of the Taxpayer. There must be some reasonably direct relationship between the payment by the Taxpayer and the benefits which it received and it must be shown that the benefits assisted the Taxpayer in earning the taxable profits against which the Taxpayer claims to deduct the payment to the association. We have no evidence regarding any of this. It may well be that membership

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of the association did assist the Taxpayer in making its profits but without any evidence we cannot so find. The onus of proof is upon the Taxpayer.

It is also necessary for the Taxpayer to show that the payment made is of an income expense nature and not a capital expense nature. In most cases, and indeed in this case, it is not difficult to differentiate between capital and income. A capital payment results in the acquisition of an asset which is of an enduring nature and which does not form part of the stock in trade of the Taxpayer. In this case the Taxpayer made a payment of \$60,000 to the association as a membership fee. \$60,000 is a substantial sum of money. If this had been an ordinary membership fee and if it were shown that membership of the association assisted the Taxpayer in earning its taxable profits then the payment would be clearly deductible from the income of the Taxpayer subject to Hong Kong profits tax. However this is not a normal membership subscription to the association but is a payment to acquire a life honourable presidency. A life honourable presidency is a valuable asset of an enduring nature. It is not something which evaporates in the course of the current year. It is something which endures into the future and is of ongoing benefit to the Taxpayer. By nature it is a capital asset of the Taxpayer, and not an income expense.

In the course of the hearing of this appeal, the representative for the Commissioner said that the sum of \$20,000 was capable of being deducted from the taxable profits of the Taxpayer because of the extra-statutory concession granted by the Commissioner in his letter of 28 February 1967. In view of this we do not propose to disallow the sum of \$20,000 which has already been allowed by the assessor and confirmed by the Deputy Commissioner in his determination dated 18 October 1990 against which the Taxpayer has appealed to this Board of Review. However, we must point out that extra-statutory concessions are not something which this Board can recognise and if the matter had been raised before the Board and not conceded by the Commissioner we would have been obliged to increase the assessment against which the Taxpayer has appealed.

For the reasons given we dismiss this appeal and confirm the assessment for the year of assessment 1986/87 dated 2 February 1988 as confirmed by the Deputy Commissioner.