Case No. D15/18

Profits tax – determination of profits tax assessment – expenses incurred for purpose of the production of profits – properties handling expenses and entertainment expenses – Inland Revenue Ordinance (Chapter 112) sections 16(1), 17(1), 61, 68, 68(4)

Panel: Wong Kwai Huen Albert (chairman), Ha Suk Ling Shirley and Lai Sze Wai Alex.

Date of hearing: 25 July 2018.
Date of decision: 27 November 2018.

Company A had objected to the Additional Profits Tax Assessments for years of assessment 2012/13 and 2013/14 ('Years of Assessment') raised on it. At the relevant times, Company A described its principal activities as 'property holding for rental income and provision of management services'. Company A did not submit its Profit Tax Returns for the Years of Assessment within the stipulated time. An Assessor of the Respondent raised on Company A an estimated Profits Tax Assessments and Additional Profits Tax Assessment for the Years of Assessment.

Company A did not object to the Assessments, which became final and conclusive. The Profits Tax Return for year of assessment 2013/14 remained outstanding and the Assessor raised an Additional Profits Tax Assessment for year of assessment 2013/14. On behalf of Company A, Messrs Mainfaith CPA Ltd ('the Representative') objected to the above assessments on the ground that the assessments were excessive. Company A subsequently filed its Profits Tax Returns for the Years of Assessment with audited financial statements and profits tax computations for year ended 31 December 2012 and 2013, including deduction of Sum A in 2012/13 and Sum B in 2013/14.

By a 19 March 2015 letter, the Assessor requested the Representative to provide information and documents to substantiate its claims for deduction of Sum A and Sum B. Neither the Representative nor Company A had replied to the Assessor's letter. The assessor disallowed Sum A. Before the hearing of this appeal, the Respondent allowed a sum of $119,000 (which was accepted by Company A) and four other items. At the material time, an agreement was entered into between Company A and one Company B for the latter to 'provide properties handling service' to Company A ('Agreement').

The issues in this appeal were whether Sum A and Sum B which comprised the various heads of expenses should be allowed for deduction in computing the assessable profits of Company A for the Years of Assessment.

Held:

1. The present Board doubted that the Agreement and the related invoices were contemporaneous documents, and found that the Agreement did not only contain flaws and defects, it actually served no meaningful purpose. The Board held that the alleged 'properties handling' expenses to be not deductible for tax purposes (Cheung Wah Keung v Commissioners of Inland Revenue [2002] 3 HKLRD 773 considered).

2. Given the grossly inadequate information contained in the invoices and receipts of entertainment expenses, they could not stand up to even the most cursory scrutiny. The Board also found a number of facts went against Company A's allegation that the entertainment expenses were for producing its own profit.

3. Company A had accepted the revisions made by the Respondent in respect of messing. In relation with the other items under messing, the Board found them to be undeductible expenses in any event as they were so obviously more of a domestic nature or for the private enjoyment by the directors than relating to the production of chargeable profits.

4. The Board found that the Sums were not deductible and Company A had failed to discharge its onus of proving the assessments appealed against were excessive or incorrect.

Appeal dismissed and costs order in the amount of $25,000 imposed.

Cases referred to:

Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773

Kelvin Leung of Mainfaith CPA Ltd, for the Appellant.
Chiu Ming Wai, Fung Ka Leung, and Lai Ming Yee, for the Commissioner of Inland Revenue.

Decision:

1. The Facts

(1) Company A ('the Taxpayer') has objected to the Additional Profits Tax Assessments for the years of assessment 2012/13 and 2013/14 raised on it. The Taxpayer claims that the assessments were excessive.

(2) The Taxpayer was incorporated as a private limited company in Hong Kong in 1974. At the relevant times, the Taxpayer described its principal activities as 'property holding for rental income and provision of management services'.

(3) At the material times, the Taxpayer did not submit its Profits Tax Returns for the years of assessment 2012/13 and 2013/14 within the stipulated time. Pursuant to section 59(3) of the Inland Revenue Ordinance ('IRO'), the Assessor of the Respondent ('the Assessor') raised on the Taxpayer the following estimated Profits Tax Assessments and Additional Profits Tax Assessment for the years of assessment 2012/13 and 2013/14:

(a) Year of assessment 2012/13

		$
(i)	Assessable Profits	50,000
	Tax payable thereon (after tax reduction)	2,062

		$
(ii)	Additional Assessable Profits	250,000
	Additional tax payable thereon (after tax reduction)	37,438

(b) Year of assessment 2013/14

	$
Assessable Profits	300,000
Tax payable thereon (after tax reduction)	165,000

(4) The Taxpayer did not object to the above assessments and they became final and conclusive in terms of section 70 of the IRO.

(5) The Profits Tax Return for the year of assessment 2013/14 remained outstanding and the Assessor raised the following estimated Additional Profits Tax Assessment for year of assessment 2013/14:

	$
Additional Assessable Profits	1,000,000
Additional tax payable thereon	165,000

(6) On behalf of the Taxpayer, Messrs Mainfaith CPA Limited ('the Representative') objected to the above assessments on the ground that the assessments were excessive.

(7) The Taxpayer subsequently filed its Profits Tax Returns for the years of assessment 2012/13 and 2013/14 together with audited financial statements and profits tax computations for the years ended 31 December 2012 and 2013.

(i) In its tax returns, the Taxpayer declared assessable profits of $307,610 for the year of assessment 2012/13 and $330,899 for the year of assessment 2013/14, which were arrived at after deducting, *inter alia*, the following expenses:

	Year of assessment	2012/13	2013/14
		$	$
(a)	Commission	-	169,000
(b)	Properties handling expenses	660,000	660,000
(c)	Entertainment	96,319	207,025
(d)	Messing	179,411	199,168
(e)	Legal and professional fee	19,725	33,310
		955,455	1,268,503
		('Sum A')	('Sum B')

(ii) The Taxpayer's detailed income statements for the years of assessment 2012/13 and 2013/14 showed, amongst other things, the following particulars:

Year of assessment	2012/13	2013/14
	$	$
Rental income	2,516,400	2,510,822
Management service income	585,000	840,000
Net valuation gains on investment properties	24,770,000	27,910,000
Dividend income from listed securities	24,744	62,081
Unrealised gains on trading securities	180,498	511,261
	28,076,642	31,834,164
Less: Sum A	955,455	-
Sum B	-	1,268,503
Other operating and administrative expenses	1,827,879	1,735,228
Profit before taxation	25,293,308	28,830,433

(8) By a letter of 19 March 2015, the Assessor requested the Representative to provide information and documents to substantiate its claims for deduction of Sum A and Sum B. Neither the Representative nor the Taxpayer had replied to the Assessor's letter.

(9) In the absence of a reply, the Assessor raised on the Taxpayer the following Additional Profits Tax Assessment for the year of assessment 2012/13 to disallow Sum A:

	$
Profit per return	307,610
Add: Sum A	955,455
Assessable Profits	1,263,065
Less: Profits already assessed	300,000
Additional Assessable Profits	963,065
Additional tax payable thereon	158,905

(10) The Representative, on behalf of the Taxpayer, objected to the above assessment on the ground that Sum A was incurred in the production of assessable profits and should be deductible under Profits Tax.

(11) In the Profits Tax Return for the year of assessment 2011/12, which enclosed the audited financial statements and tax computation, the Taxpayer declared an adjusted loss of $265,008 and a loss carried forward computed as follows:

	$
Adjusted loss for the year	265,008
Add: Loss brought forward	1,102,711
Loss carried forward	1,367,719

(12) Despite repeated reminders, the Taxpayer did not provide the information and documents requested by the Assessor. The Assessor was prepared to revise the Additional Profits Tax Assessments for the years of assessment 2012/13 and 2013/14 as follows:

Year of assessment	Additional 2012/13	Additional 2013/14
	$	$
Profits per return	307,610	330,899
Add: Sum A	955,455	-
Sum B	-	1,268,503
Assessable Profits	1,263,065	1,599,402
Less: Profits already assessed	300,000	300,000
Additional Assessable Profits	963,065	1,299,402
Less: Loss set-off	963,065	404,656
Net Assessable Profits	-	894,748
Additional tax payable thereon	-	147,633

Year of assessment	Additional 2012/13	Additional 2013/14
	$	$
Statement of loss		
Loss brought forward	(1,367,719)	(404,656)
Less: Profit for the year	963,065	404,656
Loss carried forward	(404,656)	-

(13) Before the hearing of this appeal, and upon further enquiries made by the Assessor, the Respondent allowed a sum of $119,000 representing a commission paid by the Taxpayer to an unrelated real estate agent to be tax deductable. After the hearing and upon examination of the documents submitted by the Taxpayer, the Respondent further allowed a portion each of four other items of legal and professional fees to be tax deductible.

(14) The Respondent is now prepared to further revise the Additional Profit Tax Assessments for the years of assessment 2012/13 and 2013/14 as follows:

Year of assessment	2012/13	2013/14
	$	$
Profits per return	307,610	330,899
Add: Sum A and Sum B	955,455	1,268,503
	1,263,065	1,599,402
Less: Deductible commission expenses		119,000
Deductible legal and professional fee		
($2,500 +$3,625)	6,125	-
($23,455)	-	23,455
Assessable Profits	1,256,940	1,456,947
Less: Profits already assessed	300,000	300,000
Additional Assessable Profits	956,940	1,156,947
Less: Loss set-off	956,940	410,779
Net Additional Assessable Profits	-	746.168
Additional tax payable thereon	-	123,117
Statement of loss		
Loss brought forward	(1,367,719)	(410,779)
Less: Profit for the year	956,940	410,779
Loss carried forward	(410,779)	-

2. The Issues

The issues in this appeal are whether Sum A and Sum B which comprise the various heads of expenses as stated in paragraph 1(7)(i) above should

be allowed for deduction in computing the assessable profits of the Taxpayer for the years of assessment 2012/13 and 2013/14.

3. **The Relevant Statutory Provisions of the IRO**

(1) Section 16(1)

Ascertainment of chargeable profits

'*(1) In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period…*'

(2) Section 17(1)

Deductions not allowed

'*(1) For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of -*

(a) domestic or private expenses…

(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;'

(3) Section 61

Artificial or fictitious transactions

'*Where an assessor is of the 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.*'

(4) Section 68(4)

Onus of Proof

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

4. Grounds of Appeal

(1) The gist of the Taxpayer's grounds of appeal is that all the expense items contained in Sum A and Sum B ('the Sums') were incurred for the purpose of the production of profits in the relevant years of assessment and should be tax deductible.

(2) In its final written submission, the Taxpayer has accepted the revisions made by the Respondent in relation with Items (a) Commission (d) Messing and (e) Legal and Professional fee as stated in paragraph 7(i) above. The Taxpayer proceeded with the appeal against the remaining Items i.e. (b) Properties handling expenses and (c) Entertainment in the said paragraph.

5. Finding

(1) Commission Expense – 2013/2014

The Respondent discovered that the sum of $169,000 was a commission paid to an independent real estate agent for services rendered in relation with several properties. However, one of the properties in question was in fact owned by a related company of the Taxpayer but not the Taxpayer itself. After taking into consideration that one property was not owned by the Taxpayer, the amount was considered by the Respondent to be tax deductable but was adjusted to $119,000. As mentioned above, the Taxpayer has accepted this adjustment.

(2) 'Properties Handling' Expenses – 2012/13 and 2013/14

(i) The Taxpayer clarified in evidence that at the material time it owned nine properties including shops and commercial properties which were leased out to earn rental income. There were two directors in the Taxpayer company but there was no other employee. As the two directors had to take care of other business, the Taxpayer need to find someone to handle all matters relating to the properties and their leasing activities. An agreement was therefore entered into between the Taxpayer and one Company B for the latter to 'provide properties handling service' to the Taxpayer.

(ii) As the two companies were situated at the same office with one company holding a controlling interest over the other, they decided to sign a 'simple agreement' without using the service of a law firm. The chances of disputes arising between the parties were slim; hence the terms contained in the agreement might unavoidably contain some flaws and defects.

(iii) According to the Respondent, the Taxpayer had not responded to them when the latter was being asked about the details of the 'properties handling expenses'. It was not until the Taxpayer filed its grounds of appeal on 28 February 2018, did the Respondent become aware of any agreement. Upon further enquiries, the Taxpayer disclosed that Company B provided 'the services of collecting rental income, liaison with tenants and service providers for properties repairs and maintenance, negotiation with tenants for renewal of tenancy agreements' in respect of the Taxpayer's properties. A copy of the agreement dated 27 December 2011 ('the Agreement') and two invoices were produced to the Respondent on 24 May 2018.

(iv) The Agreement contained two short paragraphs and was signed by the same person both for Company B and the Taxpayer. It was for a term of two years from 1 January 2012 to 31 December 2013 with the Taxpayer agreeing to pay a monthly fee of HK$55,000 to Company B together with 'reimbursements of all fees and expenses incurred for the services' to be provided by the latter.

(v) The two invoices appeared in every aspect identical other than one being dated 31 December 2012 the other dated 31 December 2013; and the references were one for 2012 and another for 2013. For some peculiar reason, both invoices contained a reference to 'COD' which would normally be taken as 'cash on delivery' and should have no bearing in the Agreement. The Taxpayer could not explain the reason for their appearance on the invoices. The Appeal Board shares the doubt of the Respondent whether the Agreement and the invoices were contemporaneous documents. The Board notes that despite the Respondent's repeated demands, these documents which were supposed to have been in existence since 2011, 2012 and 2013 were not produced by the Taxpayer until May 2018.

(vi) The Respondent further submits that this case is one that Section 61 of the IRO should apply i.e. the entering into the

so-called 'properties handling' agreement between the Taxpayer and Company B is an artificial or fictitious transaction and should be disregarded.

(vii) The Respondent brought the attention of the Board to the following facts:

(a) in the Agreement there were no detailed arrangements or reporting procedures relating to the alleged provisions of services by Company B to the Taxpayers; bearing in mind that the portfolio of properties which would change from time to time was not specified in the Agreement;

(b) the invoices indicated that monthly service fee was only settled once a year and in the Taxpayer's evidence, the fees for 2012-2013 were in fact not settled until 2017 by offsetting the current accounts between the two companies;

(c) there is no evidence that any service had indeed been provided by Company B to the Taxpayer; and

(d) Company B had previously suffered losses and substantial tax losses had been carried forward from year of assessment 2009/10.

(viii) The Taxpayer's only witness was one Mr C, a common director of the Taxpayer, Company B and few other related companies. Mr C did not hold any share in any of these companies. It was obvious that Mr C was employed by Mr D through his companies to attend to their business. According to him, he reported to Mr D another director and the true owner of the said companies. Mr C admitted that he was the signatory on the Agreement signing on behalf of both the Taxpayer and Company B.

(ix) Mr C confirmed in evidence that the person from Company B who actually provided the so-called 'properties handling services' to the Taxpayer was one Mrs E, the wife of Mr D. However, there was no contract between Mrs E and Company B. It was just an oral agreement that Mrs E would help Company B. According to the Respondent's records, Company B had never filed any Employer's Returns of Remuneration and Pensions for the relevant years of assessment. In her own Tax Return – Individuals for the period from 1 April 2013 to 31 March 2014, Mrs E declared

that she only received salary income from one Company F. There was no salary income from the Taxpayer. She did not file any tax return for the previous year of assessment.

(x) In Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773, Woo JA said that:

'*The term "commercially unrealistic" appears in CIR v Hower (1977) 1 HKTC 936 at p.952 in the sense of "unrealistic from a business point of view". We are of the view that whether a transaction which is commercially unrealistic must necessarily be regarded as being "artificial" depends on the circumstances of each particular case. We agree with the submission of Mr Cooney [counsel for the Commissioner], however, that commercial realism or otherwise can be one of the considerations for deciding artificiality. In the present case, the Board found as a fact that there was no "commercial reality in the transaction" and that there "simply was no commercial sense in the transaction.*'

(xi) The Board takes the view that anyone who enters into an agreement must do so with a purpose, for example, to acquire or provide certain goods or service. Both parties must at least believe that they will be able to fulfill its obligations under the agreement. In this case, Mr C gave evidence that all the tenants of the Taxpayer would pay their rentals directly to the Taxpayer's bank account. He also mentioned that from time to time he had to deal with the enquiries and complaints made by the tenants. There was also evidence that the Taxpayer would use the services of independent real estate agents or other professionals. Then the question is what 'properties handling service' was there left for Company B to do. In fact, another difficult question which baffled the Board is who from Company B would and could offer any service at all if there was no person employed by Company B to do so.

(xii) Yet again, another question is why then the Taxpayer would enter into the Agreement knowing that Company B could not possibly offer any service. This fact must be known to both parties since Mr C was the person who signed the Agreement on behalf of both of them.

(xiii) The Board finds that the Agreement did not only contain flaws and defects, it actually served no meaningful purpose. The Agreement was a crude and makeshift document lacking all the usual terms and details normally expected to be contained in a document of this nature. Mr C signed on the Agreement

in both his capacity as a director of the Taxpayer as well as Company B. Mr C also signed and issued two invoices on behalf of Company B to purportedly charge the Taxpayer the Properties Handling Service Fees for the years of 2012 and 2013. The fees were not paid but were allegedly 'settled' by offsetting the current accounts between the two companies until 2017. The Board finds that the Agreement was commercially unrealistic and was blatantly artificial and fictitious. It is so obvious from the evidence that the Agreement was no more than an afterthought with the sole purpose of passing some of the Taxpayer's profit over to Company B which was sitting on a substantial sum of accumulated loss.

(xiv) The Board has no hesitation in holding the alleged 'properties handling' expenses to be not deductible for tax purposes.

(3) Entertainment Expenses – 2012/13 and 2013/14

(i) Despite repeated requests made by the Respondent, the Taxpayer had not provided a breakdown of the entertainment expenses showing details such as the date, amount and the nature of the expense items. The Taxpayer simply collected a large volume of what appeared to be copies of invoices or receipts, a lot of them showed no date or description of any kind or any other details than simply an amount of money. The writing in some of the invoices or receipts was even illegible. According to the Taxpayer, the total sum of the receipts should add up to $93,552 and $195,122.9 supposedly to support the claims for entertainment expenses for the two relevant years of assessment.

(ii) Mr C candidly admitted that all the occasions on which the alleged entertainment expenses were incurred, he only personally participated in a few, and he roughly estimated that he attended about one-forth of them. Yet, Mr C seemed to know exactly the purpose of each and every occasion which he described as 'mingling with business contacts such as estate agents, bankers and professionals'. The Taxpayer produced pages of name cards of people with various backgrounds. Presumably, these were the people the Taxpayer had entertained. No details of these people nor explanation of why they were included were given at the hearing.

(iii) Given the grossly inadequate information contained in these invoices and receipts, they cannot stand up to even the most cursory scrutiny. Further, the Board finds the following facts

go against the Taxpayer's allegation that the entertainment expenses were for producing its own profit:

(1) Most of the meal expenses were settled with the use of Mrs E's personal credit card. As already mentioned above, it is the Taxpayer's evidence that Mrs E was not a director or an employee of the Taxpayer. Other than being Mr D's wife, she was not connected with the Taxpayer. It is therefore doubtful whether she paid for the meals on behalf of the Taxpayer.

(2) There was absolutely no evidence of how each of the occasions on which entertainment expenses had been incurred were related to the Taxpayer's business.

(3) Mr D was a director of at least nine other related companies, many of which were also holding properties. It is not possible to prove that he was entertaining business contacts for the sole benefit of the Taxpayer.

(4) There were some extraordinary items of expenses which would fly in the face of common sense if they were considered to have been incurred for a business purpose. They included the bill of a party at a country club involving 30 adults and 20 children; the price of a birthday cake for the daughter of Mr D and the donations made by unknown people to a couple of monasteries.

(5) In any event, according to the Respondent, the total sums of the receipts and invoices did not tally with the sums of the actual amount of Entertaining Expenses claimed by the Taxpayer for the relevant years of assessment.

(6) In view of the above, the Board finds that the entertainment expenses were not incurred during the relevant years of assessment for the purpose of producing chargeable profits. They should not be deductable.

(4) Messing – 2012/13 and 2013/14

As mentioned above, the Taxpayer has accepted the revisions made by the Respondent in respect of this item. In its final submission, the Taxpayer referred to a few receipts relating to the purchase of certain articles which the Taxpayer submitted that even if they did

not qualify to be messing expenses, they should at least be considered as capital expenses so as to be entitled to depreciation. Since it is an accounting treatment issue, it is beyond the remit of the Board.

In relation with the other items under messing, the Board would find them to be undeductible expenses in any event as they were so obviously more of a domestic nature or for the private enjoyment by the directors than relating to the production of chargeable profits. The Board would have no difficulty in finding those items to be not deductible from tax including liquid gas, rice, herbs, mooncakes, fung shui articles, dog food etc.

(5) Legal and Professional Fee – 2012/13 and 2013/14

As the Taxpayer has accepted the revisions made by the Respondent under this heading, the Board makes no finding in this regard.

6. Conclusion

(1) With the exception of those revisions made by the Respondent, the Board finds that the Sums are not tax deductable and the Taxpayer has failed to discharge its onus of proving the assessments appealed against are excessive or incorrect. The assessments for the years of assessment 2012/13 and 2013/14 as stated in paragraph 1(14) above are confirmed.

(2) The Taxpayer is ordered to pay costs in the sum of $25,000.