Case No. D19/19

Profits tax – special annual bonus – whether deductible for the purpose of profits tax – whether incurred 'in the production of profits' – whether preferential dividends – sections 16, 17, 68(4), (8) & (9) of and Part 1 of Schedule 5 to the Inland Revenue Ordinance (Chapter 112) ('IRO')

Panel: Cissy K S Lam (chairman), Law Chung Ming Lewis and Richard Zimmern.

Dates of hearing: 23-24 May 2019.
Date of decision: 3 December 2019.

The Appellant was a company operating a funeral parlour. In the original Articles of Association of the Appellant ('AA'), Article 54 entitled the two promoters to a bonus equivalent to 10% of the net profit after tax, to be divided equally between them. Article 55 stipulated that the bonus should be permanent, and the two promoters were entitled to transfer their benefit to their heirs, executors and administrators in the event of their death.

According to the Appellant, since funeral service industry was generally viewed with distaste, it could not openly advertise and had to depend on referrals. Hence, in 1991, a special annual bonus ('SAB') scheme was established to provide motive for the 'operational shareholders' to reach out to different sectors of the community to build connections and network with potential customers. Pursuant thereto, Article 54 and 55 were deleted and substituted: (a) the two promoters were replaced by 20 'entitlement members' (who were also shareholders of Appellant) with entitlement at fixed ratios; (b) computation of SAB remained 10% of the net profit after tax but before distribution of dividends to the shareholders; (c) SAB was likewise permanent in nature, and was transferrable to the entitlement members' heirs and successors in the event of death; (d) in addition, entitlement members could transfer their entitlement to other persons or corporations upon the Board of Executive Directors' approval. During the years of assessment 2000/01 to 2011/12 ('Relevant Years'), SABs were paid to various recipients ('SAB Recipients').

In 2013, the Appellant increased its authorized share capital by creating 10,000 non-voting preference shares of $1 each, and Articles 54 and 55 were deleted and substituted by a new set of provisions under the title 'Preference Shares' whereby the holders of the preference shares collectively had the right to receive annual dividends equivalent to 8.3% of the Appellant's audited net profit after tax. The preference shareholders were either the original entitlement members or persons/corporations associated with them. The ratio of entitlement corresponded with the ratio of entitlement under the 1991 version of Articles 54 and 55.

In the Profits Tax Returns between 2000/01 and 2011/12, the Appellant

claimed deduction of SABs. Upon review of the Appellant's claim, the Assessor considered that SAB amounted to appropriation of the Appellant's profits and were not deductible. Upon the Appellant's objection, the Commissioner found that SABs were not 'outgoings and expenses' but were in nature an appropriation of profits, and they were not incurred 'in the production of profits'. The Appellant appealed against the determination. In the appeal, the Appellant relied on the evidence of Mr E, one of the sons of the promoter, who alleged that, inter alia, the SABs were paid to the SAB Recipients for (a) bringing in business; (b) advising on the business; and (c) remaining in the business.

Held:

Legal principle

1. Section 16(1) of IRO stipulated that for 'outgoings and expenses' to be deductible, they must be incurred 'in the production of profits'. To the same effect, section 17(1)(b) stipulated that 'no deduction shall be allowed in respect of any disbursements or expenses not being money expended for the purpose of producing such profits'. In determining whether a payment was a deductible expense, the Court must look at all surrounding circumstances, e.g. (a) the relationship between the payer and the payee, (b) the purpose or reason of the payment and (c) the basis and the breakdown of the amount. The lack of rational basis might lead to the conclusion that the amount was wholly arbitrary, lacking in commercial reality, and thus not *bona fide* incurred. The test was simply an employment of common sense. The burden of proof was on the Appellant (D94/99, IRBRD, vol 14, 603 and So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416 considered).

Analysis

2. Whilst the Board had no desire to impeach Mr E's integrity, his evidence must be tested against all the facts and circumstances. The Board found that Mr E's evidence went against the weight of the object documents and evidence.

3. SAB had all the hallmark of preferential dividends/distribution of profits to a selected number of shareholders (akin to preference shareholders). The SABs were not included 'in the production of profits' or 'expended for the purpose of producing such profits'. This was because: (a) the Appellant's claim that SABs were paid to SAB Recipients for bringing in business was not supported by facts; (b) the supporting documents were non-contemporaneous and self-serving; (c) there was no independent document to prove that SAB Recipients referred business, let alone majority of the business, to the Appellant; (d) if any of the SAB Recipients did make any referral, the Appellant never bothered to keep any record; and to now claim that SAB was paid as a reward for the

business brought in seemed very much an afterthought; (e) the structure of the SABs scheme – by fixing the ratio of the entitlement, by making the entitlement transferrable, by embodying the scheme in the AA were all consistent with the scheme being a scheme for preferential dividend than the payment of bonus as an incentive or reward for work done; (f) the formula for computing SAB being 10% of the net profit after tax was a further indication that SAB was not an item of expenditure. To argue that a sum equivalent to '10% of the net profit after tax' was a tax-deductible item of expenditure was a contradiction in terms; (g) the replacement of SABs scheme by the issue of preference shares was another indication that the whole scheme from start to finish was intended to be a distribution of preferential dividends.

Costs

4. The appeal had little merit. The Board considered it appropriate in the circumstances to order the Appellant to pay the maximum costs of $25,000 specified under section 68(9) and Part 1 of Schedule 5 to IRO.

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

Cases referred to:

D94/99, IRBRD, vol 14, 603
So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416

Caspar Ng, Counsel, instructed by Messrs Edmund W H Chow & Co, for the Appellant.
Julian Lam, Counsel, instructed by Department of Justice, for the Commissioner of Inland Revenue.

Decision:

1. The Appellant objected to the Additional Profits Tax Assessments for the years of assessment 2000/01 to 2006/07, 2008/09 and 2009/10 and the Profits Tax Assessment for the years of assessment 2007/08, 2010/11 and 2011/12 (collectively 'the Relevant Years'). The Appellant contended that certain 'special annual bonus' ('SAB') was deductible from its assessable profits as part of its expenses under section 16(1) of the Inland Revenue Ordinance ('IRO').

2. By Determination dated 4 September 2018 ('the Determination'), the Deputy Commissioner of Inland Revenue ('the Commissioner') confirmed all the Additional Profits Tax Assessments and Profits Tax Assessments except one for reasons

that do not concern us.[1]

3. Dissatisfied with the Determination, by Notice of Appeal dated 3 October 2018, the Appellant appealed to this Board.

The Undisputed Facts

4. The Appellant was incorporated as a private company in Hong Kong in July 1968. Its principal business activity was the operation of a funeral parlour. It closed its accounts on 31 December annually.

5. The SAB was laid down in Articles 54 and 55 of the Articles of Association of the Appellant (the 'AA').

6. **The original Version**: In the original AA dated 29 July 1968, Article 54 entitled the two promoters (Mr B and Mr C) to a bonus equivalent to 10% of the net profit after tax of the Company, to be divided equally between them.

7. Article 55 stipulated that the bonus should be permanent, and entitled the two promoters to transfer their benefit to their heirs, executors and administrators (provided they were the registered owners of at least one share in the Appellant) in the event of their death.

8. **The 1991 Version**: By Special Resolutions passed on 27 January 1991 (Appendix One hereto), Articles 54 and 55 of the AA were deleted and substituted:

(1) Essentially, the 2 original promoters were replaced by 20 different 'Entitlement Members' with entitlement at fixed ratios ranging from 25.95% to 0.47%.

(2) The computation of the SAB remained largely the same, namely 10% of the net profit after tax but before the distribution of dividends to the shareholders. An example of how the SAB was to be calculated was set forth in the new Article 54(d).

(3) The SAB was likewise permanent in nature, and was transferable to the Entitlement Members' heirs and successors in the event of death.

(4) In addition, the Entitlement Members could transfer their entitlement to other persons or corporations upon the Board of Executive Directors' approval.

9. All the Entitlement Members were also shareholders of the Appellant at

[1] The Commissioner revised the Profits Tax Assessment for the year of assessment 2007/08 to allow for deduction of building refurbishment expenditure.

the date of the 1991 Special Resolution.[2]

10. During the Relevant Years, i.e. from 2000/01 to 2011/12, the SABs were paid to various recipients ('SAB Recipients'). The payment to these SAB Recipients could be traced back to the Entitlement Members as per the table set out in paragraph (7)(d) of the Determination (Appendix Two hereto).

11. **The 2013 Version**: By Special Resolutions passed on 17 April 2013 (i.e. after the Relevant Years), the Appellant increased its authorised capital by creating 10,000 non-voting preference shares of $1 each, and Articles 54 and 55 were deleted and substituted by a new set of provisions under the title 'Preference Shares' whereby the holders of the preference shares collectively had the right to receive annual dividends equivalent to 8.30% of the Appellant's audited net profit after tax. The preference shareholders were either the original Entitlement Members or persons or corporations associated with them. The ratio of entitlement corresponded with the ratio of entitlement under the 1991 version of Articles 54 and 55.

12. **The Profits Tax Returns**: In its Profits Tax Returns, the Appellant claimed deduction of SABs in the following sums:

2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
$6,727,654	$5,507,361	$5,647,396	$4,842,408	$5,465,061	$5,222,707

2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
$5,590,624	$7,175,043	$8,386,821	$7,748,222	$7,907,634	$7,823,537

13. For the years of assessment 2000/01 to 2004/05, the SABs were declared in the Appellant's audited financial statements as 'appropriations' deducted from the net profit of the year after taxation.

14. For the years of assessment 2005/06 to 2011/12, the SABs were declared in the audited financial statements as 'expenses' (see paragraph 84 below).

15. Upon a review of the SAB deduction claim, the Assessor considered that the SABs amounted to appropriation of the Appellant's profits and were not deductible.

Relevant Provisions of the IRO

16. Section 16(1) of the IRO stipulated that for 'outgoings and expenses' to be deductible, they must be incurred 'in the production of profits'.

17. To the same effect, section 17(1)(b) stipulated that '*no deduction shall be allowed in respect of any disbursements or expenses not being money expended for the*

[2] One of the SAB Recipients, Mr D, passed away on 7 May 1991.
A list of the 49 shareholders of the Appellant and their respective shareholdings in 1991 was appended to the Determination

purpose of producing such profits.'

18. Section 68(4) of the IRO lays the burden of proof on the Appellant.

19. In D94/99, the Board stated the test as follows:

> '*24. ... The question here is whether that payment is a deductible expense in law when computing the chargeable profits. This question must be answered objectively. The agreement between the Taxpayer and Company D does not preclude us from examining whether the payment is or is not a deductible expense incurred in the production of profits.*
>
> *25. Such expense must have been bona fide incurred in the production of profits. We must look at all surrounding circumstances. For example, the relationship between the payer and the payee is a relevant circumstance. So is the purpose or the reason of the payment. The basis and the breakdown of the amount are also important. The lack of a rational basis may lead us to the conclusion that the amount is wholly arbitrary, lacking in commercial reality, and thus not bona fide incurred.*'

20. These paragraphs were quoted with approval in So Kai Tong v CIR [2004] 2 HKLRD 416, 426-427 paragraph 24.

21. There were lengthy discussions in Counsel's Closing Submissions on 'Subjective Intention' v 'Objective Intention' and 'Effect' v 'Object'. We do not find such discussions necessary or helpful. The test stated in D94/99 is simply an employment of common sense. Even where subjective intention is the test, that intention must be bona fide; and it cannot be proved by a bare statement or assertion, but has to be tested against all the surrounding circumstances.

The Determination

22. The Commissioner found that (1) the SABs were not 'outgoings and expenses', but were in nature an appropriation of profits, and (2) they were not incurred 'in the production of profits'.

23. The Appellant disputed both findings in its Statement of Grounds of Appeal, Grounds 1 and 2.

The Witness

24. The Appellant called one witness, namely Mr E. He together with his brother Mr F are the sons of the promoter Mr B. The two brothers were both SAB Recipients. Together they held 25.95% entitlement, same ratio as the other promoter Mr C,

who was still living at the time of the 1991 Special Resolution.

25. The two brothers via their company Company G held 14.16% of the shareholding of the Appellant.

26. Mr E was and is the director and general manager of the Appellant. He became a director in 1981 and general manager in about 1982.

27. He made 3 Statutory Declarations dated respectively 31 August 2009[3], 7 May 2019 and 14 May 2019, and he gave oral evidence.

28. The Appellant relied heavily on various assertions made by Mr E in his Statutory Declarations and his oral testimony. Counsel for the Appellant in his Closing Submissions spent many paragraphs arguing why Mr E was a credible witness. We have no desire to impeach Mr E's integrity. Suffice to say that one cannot rely on oral testimony and bare assertions alone. We repeat paragraph 21 above. Mr E's evidence must be tested against all the facts and circumstances. And we find that Mr E's evidence went against the weight of the objective documents and evidence.

This Board's Decision

29. On the facts and evidence, we agree with the Commissioner that the SAB had all the hallmark of preferential dividends/distribution of profits to a select number of shareholders (akin to preference shareholders). The SABs were not incurred 'in the production of profits' or 'expended for the purpose of producing such profits.'

30. We come to our conclusion on the following grounds:

(1) The Appellant's claim that the SABs were paid to the SAB Recipients for bringing in business was not supported by the facts.

(2) The supporting documents were non-contemporaneous and self-serving.

(3) There is not a single independent document to prove that the SAB Recipients referred business, let alone majority of the business, to the Appellant.

(4) If any of the SAB Recipients did make any referral, the Appellant never bothered to keep any record. And to now claim that the SAB was paid as a reward for the business brought in seems very much an afterthought.

(5) The structure of the scheme – by fixing the ratio of the entitlement, by making the entitlement transferable, by embodying the scheme

[3] The first Statutory Declaration was appended to the Determination as Appendix I

in the AA were all consistent with the scheme being a scheme for preferential dividend than the payment of bonus as an incentive or reward for work done.

(6) The formula for computing the SAB being 10% of the net profit after tax was a further indication that the SAB was not an item of expenditure. To argue that a sum equivalent to '10% of the net profit after tax' is a tax-deductible item of expenditure is a contradiction in terms.

(7) The replacement of the SAB Scheme by the issue of preference shares was another indication that the whole scheme from start to finish was intended to be a distribution of preferential dividends.

The Appellant's case

31. Essentially, the Appellant's case was this:

(1) As the funeral service industry is an industry generally viewed with distaste, the Appellant could not openly advertise its business. Its business depended mainly on referrals.

(2) In 1991 when the SAB scheme was established, there were 49 shareholders in the Appellant company comprising people of different sectors and backgrounds. Some of the shareholders held shares in the company and no more. On the other hand, there were those shareholders who contributed to the operation of the business by bringing in and advising on the business.

(3) A significant portion of the Appellant's business was brought in by these 'Operational Shareholders'.

(4) In 1991, 17 of the 20 'Operational Shareholders' or their representatives were the Appellant's employees. The other 3 were not employed by the Appellant for various reasons, e.g. they had retired or they held other offices, etc. As such they were not remunerated for their contributions.

(5) The SAB provided a motive for the 'Operational Shareholders' to reach out to different sectors of the community to build connections and network so that when the time came, potential customers would go to the Appellant instead of other funeral parlours.

32. In Counsel's Closing Submission for the Appellant, it was argued that the SABs were paid to the SAB Recipients for (1) bringing in business; (2) advising on the business; and (3) remaining in the business.

33. We find the dissection into 3 sections artificial. By 'advising on business', Counsel was referring to Mr E's Statutory Declarations where he said that the Operational Shareholders would be consulted on the preference of their referrals, e.g. whether the client would be more content with a budget funeral or a grand funeral, or how to resolve conflicts of traditions. Such 'advice' was services ancillary to the referrals they made and was part and parcel of the 'bringing in business'.

34. As to 'remaining in the business', Counsel was repeating Mr E's reference to the aversion incidental to the funeral service industry and that the SAB was paid to encourage the Operational Shareholders to remain in the business. That did not add anything to the 'bringing in business'.

The Appellant's case inconsistent with the facts

35. The Appellant's case explained very well why the Operational Shareholders were set apart as a select group of shareholders; why when it was thought desirable in 1991 to give this select group of shareholders an additional share in the net profit beyond their shareholders dividend there was no objection. What it had not explained, however, was that if the bonus was intended to encourage the Operational Shareholders to continue their contribution (as opposed to a reward for past contribution), why did it not give them an annual bonus that was proportional to the amount of business referrals and reviewable every year. In particular, 17 of the 20 Operational Shareholders were employees of the company at the time. It would have been easy to add a term in their employee agreements. Even for the 3 who were not employed by the company, a commission contract could have been signed with them.

36. Instead the Appellant chose to structure the SAB in such a way that the ratio of the entitlement was fixed and the entitlement was permanent so that it survived beyond the Operational Shareholders' retirement, and even beyond their death.

37. The consequence of that was that recipients (such as the surviving wives and children) who might no longer be 'operational', who might not have made any notable contribution to the business and who might not know anything about the funeral service business, let alone 'specialised knowledge', would still get paid. How can one justify an incentive scheme like this?

38. Mr E tried to do so by repeatedly placing his emphasis on 'connections' and 'network', the suggestion being that connections and network could endure beyond the Operational Shareholders' retirement, and even to his wives and children.

39. In the absence of evidence this was no more than a doubtful postulation. The Operational Shareholders might have 'reached out to different sectors of the community' in 1991[4], but there is no evidence that their wives and children had done the same. There is no evidence that the wives and children did anything to foster 'connections'

[4] Mr E's Statutory Declaration 14/5/2019

and 'network', old or new. The case of Madam H[5] who had emigrated to Country J was a notable example.

40. Mr E tried to generalise his answers by treating the Operational Shareholders / Entitlement Members and the SAB Recipients as if they were the same, but they were not. The Operational Shareholders might be a major force in bringing in business to the Appellant in 1991, but it was a non sequitur that their wives and children would do the same.

41. We have not lost sight of the fact that about half of the Operational Shareholders / Entitlement Members had retained their entitlements, viz. many SAB Recipients were also the original Entitlement Members; but the point is not whether any transfer had been made, rather it is the fact that the SAB would be paid irrespective of any transfer which marred its characteristic as a reward or incentive for work done.

42. Moreover, even with the Operational Shareholders, the fact that they were able to make substantial contribution to the Appellant's business in 1991 when they were working for the Appellant did not mean that they would be able to continue the same contribution after their retirement, and many of them had retired in the course of time.

43. In particular, we note from the table produced by the Appellant setting out the business connection of the Entitlement Members / SAB Recipients ('Business Connection Table') that many of them had no business connection other than being employees of the Appellant. We fail to see how such connection was fostered or maintained after their retirement.

44. If the Appellant maintains that despite any transfer of entitlement or the passing of time, the SABs continued to be a major force in bringing in business to the Appellant, then the proof of the pudding is in the eating. The best proof is to look at the actual figures and see whether they substantiate this claim.

No supporting document

45. Mr E gave evidence that only 5% of the Appellant's business was walk-in, the rest was referrals from the SAB Recipients. To support such figures, one would expect to see records, accounts or financial statements. None was forthcoming. The figures seemed to be in Mr E's head only.

46. In his Statutory Declaration of 14 May 2019, he included as Appendix A a 'summary of each of the SAB recipients' contributions' ('Sales Summary A').

47. Mr E averred that the amount of business particularised in Sales Summary A was calculated from the Funeral Services Registration Forms (殯儀服務登記表) ('Registration Form'). Samples of these Registration Forms were produced. They were

[5] She was the surviving widow of Mr K

basically forms that the deceased's family would fill in to give particulars of the deceased person and to indicate what ceremonial or other items the family would like to include in the service (e.g. Buddhist chanting, decoration of the funeral hall, etc).

48. These sample Registration Forms were separated into bundles, each with a covering note ('Covering Note') which purportedly connected the Registration Forms to a particular SAB Recipient.

49. For example, the first Covering Note stated in Chinese: G公司2007年七月至十二月(i.e. Company G Year 2007 July to December). Another Covering Note stated in Chinese: L女士2007年七月至十二月(i.e. Madam L Year 2007 July to December). By these Covering Notes, Mr E sought to prove that the attached bundles of Registrations Forms comprised of business referred to the Appellant by Company G and by Madam L respectively from July to December 2007.

50. There were many problems with these documents: first and foremost, while the Registration Forms were contemporaneous documents (made when the family of a deceased person requested the service of the Appellant), the Covering Notes were not. Mr E frankly admitted that the Covering Notes were created for the purpose of answering queries raised in the Assessor's letter of 2 September 2009.

51. The contemporaneous documents, i.e. the Registration Forms themselves, contained nothing to indicate that the particular funeral services were indeed referrals by Company G or by Madam L.

52. The Registration Forms only indicated the sales representatives that handled the particular funerals. Mr E tried to connect a sales representative with a SAB Recipient by saying that there was a master-disciple ('師傅-徒弟') relationship between the two. So, for example, if Mr M was the sales representative of a funeral, then Mr E would allocate that funeral as Madam L's referral because, according to him, Mr M was Madam L's disciple; similarly, if either Mr N or Mr P was the sales representative, then he would allocate that funeral as Company G's referral.

53. Such allocation was arbitrary and fallacious. Even assuming for the moment that whenever Madam L referred a funeral to the Appellant, she would ask her 'disciple' Mr M to handle that funeral, it did not follow that all funerals handled by Mr M must be Madam L's referrals. That funeral could be a walk-in; that funeral could be Mr M's own family and friends. As a sales representative, Mr M earned commission for each funeral he handled.[6] It was in his own best interests to refer as many funerals to the Appellant as possible. So to assume that all funerals handled by Mr M were Madam L's referral was a fallacious assumption.

54. Moreover, it seems that some sales representatives were disciple to more than one master. For example, in 2011, funerals handled by the sales representative Mr Q

[6] Mr E's evidence was that the commission was 15% of the cost of the coffin.

were allocated to 4 different SAB Recipients [7]. Such resulted in Sales Summary A giving a combined 'sales amount' of the 4 SAB Recipients instead of individual figures for each SAB Recipient.

55. The combined sales amount was only 2.08% which was a very small percentage. It could be the contribution of one of the 4 SAB Recipients alone; or it could be the contribution of one of the 4 SAB Recipients plus walk-in customers; or it could be the contribution of one of the 4 SAB Recipients plus walk-in customers plus Mr Q's own family and friends. The probabilities are plenty.

56. The same applied to the sales representative Mr R which was also artificially connected to 4 SAB Recipients.[8]

57. The case with another sales representative Mr S is also noteworthy. Mr S himself was a SAB Recipient. Yet funerals handled by him were allocated to not just himself, but himself with another SAB Recipients Mr T. It is not possible to know how much business was brought in by each.

58. So to retrospectively and artificially allocate a sales representative to one or more SAB Recipients was simply unworkable. What all these boils down to is that there is not a single independent document to prove that the SAB Recipients referred business, let alone majority of the business, to the Appellant. If any of the SAB Recipients did make any referral, the Appellant never bothered to keep any record. And to now claim that the SAB was paid as a reward for the business brought in seems very much an afterthought.

Scheme consistent with distribution of Preferential Dividend

59. Apart from having no independent proof, as said above, the structure of the scheme was inconsistent with it being a reward or incentive for 'bringing in business'.

60. No pre-condition for entitlement: Unlike a normal salary or commission or bonus where one finds all relevant terms and conditions stipulated in a service contract or employment agreement, the legal basis for the SAB was Articles 54 and 55 of the AA. This is unusual to say the least.

61. More importantly, Articles 54 and 55 merely set forth how the SAB was calculated and the ratio of the entitlement, nowhere did they say that the Entitlement Members (and subsequently the SAB Recipients) must provide services to the Appellant in order to earn their share of the SAB. The assertions of Mr E that the SAB was paid as incentive or reward for the Entitlement Members (and subsequently the SAB Recipients) to bring in business was nowhere to be found.

62. On the face of Articles 54 and 55, the Entitlement Members (and subsequently the SAB Recipients) were entitled to their share of the SAB irrespective of

[7] Namely (1) Madam H, (2) Company U1, (3) Company U2 and (4) Mr U3 and Mr U4

[8] Funerals handled by him were allocated to (1) Company V1, (2) Company V2, (3)Mr V3 and (4) Madam V4

any services provided. There would be no 'breach of contract' even if an Entitlement Member (or SAB Recipient) retired or emigrated abroad or died.

63. Ratio Fixed: An incentive or reward normally works on the basis that the more one works, the more one gets. Such had no application in the case of the SAB where the ratio of entitlement was fixed in the AA which meant that the ratio could not be altered save by an amendment of Article 54 by special resolution, i.e. a majority of at least 75% of the shareholders. It made no commercial sense to structure an incentive scheme in this way.

64. The Appellant averted to the possibility of amendment and claimed that an annual review of the SAB was made by the Board of Directors. We do not believe that any review, or at least any proper and official review, was ever made. The facts speak for themselves. The ratio of entitlement remained unchanged since 1991 and survived beyond the 2013 amendment.

65. Moreover, we fail to see how any meaningful review could have been made if there was no contemporaneous record, accounts or statements to assess the amount of business brought in by the respective SAB Recipients.

66. And if reviews were made by the Board, there would be minutes to detail such reviews. Again, none was forthcoming.

67. The Appellant argued that the Board of Directors took the view that the ratio of contribution made by each recipient remained the same and thus adjustment was not necessary. Such an argument was plainly contrary to the facts.

68. At the request of this Board, the Appellant produced a condensed sales summary ('Sales Summary B') to make it easier to compare the annual sales amount of the SAB Recipients from 2000 to 2012. Sales Summary B demonstrated that the ratio of contribution putatively made by each recipient had not remained the same. Two particular examples stood out: Madam V4 and Mr K.

69. For Madam V4:

(1) She was the administratrix of Mr W. His SAB entitlement was 1.86%.

(2) Probate was granted in 1995 and the transfer of entitlement was approved in 1998.

(3) The Sales Summary B showed that while Madam V4 brought in business at 5.60%, 6.42% and 4.96% in 2000, 2001 and 2002 respectively, she did not bring in any business in 2003.

(4) In 2004 she brought in some business to the tune of 1.94%. But from 2005 to 2012, the percentage of business putatively brought in by her was left blank.

(5) Despite such fluctuation, her entitlement had remained constant at 1.86%.

70. Mr K:

(1) He was an original Entitlement Member. His SAB entitlement was 0.47%.

(2) The Sales Summary showed that Mr K brought in business at around 3-4% from 2000 to 2003 respectively.

(3) In 2004, it was dropped to 1.94%. In the same year in June, Mr K's entitlement was transferred to his widow Madam H.

(4) It would seem that the transfer was the reason for the drop to 1.94% because after 2004, the percentage of business putatively brought in by Madam H was left blank.

(5) Nonetheless, her entitlement had remained constant at 0.47%.

71. Ratio not Proportional: The above figures further demonstrated that the ratio of SAB entitlement was not proportional to and did not depend on the percentage of business brought in by the SAB Recipients.

72. Why was Madam V4 entitled to only 1.86% of the SAB when the business she brought in was around 5%? Why was Mr K entitled to only 0.47% of the SAB when the business he brought in was between 3-4%?

73. In cross-examination at the hearing, two other examples were addressed to highlight the same point:

(1) Madam L – she was the surviving widow of the late Mr C (one of the two promoters). As such, she was the SAB Recipient with the highest percentage entitlement, namely 25.95%. [9] Yet the percentage of business putatively brought in by her was consistently well below 25.95%, with the highest being 16.01% in 2007 and the lowest 7.33% in 2000.

(2) Mr S and Mr T – their entitlements were respectively 0.93 and 1.86% only, yet the percentage of business putatively brought in by them combined were mostly around the 7% to 8% range.

74. A close examination of Sales Summary B revealed many more examples.

[9] The original Entitlement Member was Mr C, one of the two promoters. The entitlement was transferred to Company X1 in 1991, back to Mr C in 1992, to Company X2 in 1994 and to Madam L in 2004.

One cannot find any correlation between the percentage of business putatively brought in by the SAB Recipients and the ratio of entitlement.

75. The case of Madam L is noteworthy in another respect – the SAB Recipients connected to the two promoters (namely, Madam L and the Mr E and Mr F Brothers) retained the largest share of the SAB at 25.95% each. They were also the largest shareholders. Together they controlled 29.48% of the shareholding. So even though Madam L's contributions to the Appellant's business were well below 25.95%, and likewise for the Mr E and Mr F Brothers, together they could block any attempt to seek to reduce their lion shares of the SAB. Such an unfair arrangement is another pointer against the SAB being a scheme to incentivise the SAB Recipients to bring in business.

76. On the question of proportionality, we would also mention one point. In the Business Connection Table, we note that Mr T was the only one among the SAB Recipients with an apparently useful connection – the operation of Cemetery Z. Yet he was entitled to only 1.86% of the SAB, like some of the retired sales manager, and that ratio remained unchanged from 1991 to 2013 and beyond.

77. Entitlement Transferable: We repeat paragraphs 36 to 40 above.

Formula consistent with computation of Preferential Dividend

78. In addition, the Appellant had to overcome the hurdle posed by the formula used in the computation of the SABs. This formula was stipulated in Article 54(a) of the AA (1991 version), namely SAB = 10% of Net Profit after tax.

79. Article 54(d) set out an example of the computation as follows:

> 54. (d) For the avoidance of doubt, an example is given below for the calculation of the Special Annual Bonus derived from the net profit as follows:

Gross Profit for the year, say			$5,000,000.00
Less:	Operation and Management Expenses etc., say		$2,000,000.00
			$3,000,000.00
Less:	Profits Tax (Corporation Tax) for the year, say:	-	$ 500,000.00
			$2,500,000.00
10% Special Annual Bonus thereon			$ 250,000.00

> R% = Tax Rate
> X = Taxation
> Y = Special Annual Bonus
> X = R% (Profit Before Taxation – Y ± Tax Compution Adjustment)
> Y = 10% (Profit Before Taxation – X)

80. A sum payable out of the net profit is by definition not an item of expenditure.

'Net profit' = 'gross profit' – 'expenses'.

81. To argue that a sum equivalent to '10% of the net profit after tax' is a tax-deductible expenditure is a contradiction in terms.

82. This was illustrated by the Appellant's Audited Financial Statements ('AFS'). For the years of assessment 2000/01 to 2004/05, the Appellant's AFS followed faithfully the formula laid down in Articles 54(a) & (d). Hence the SAB was declared as an 'Appropriation' in the accounts, not 'expenditure'. The SAB together with the Dividends and Cash Bonuses (common to all shareholders) were all declared under one head 'Appropriations'.

83. The Assessor raised query on the SAB by letter of 19 July 2005 pointing out that 'appropriation of profits' could not be allowed for tax deduction.

84. As a result of that letter, from 2005/06 onwards, the accounting treatment was changed. As demonstrated by the 2005/06 Income Statement:

	HK$
Income	88,589,972
Less:	
Expenses	
(Including SAB of **5,222,707** ^)	31,678,775
Profit before taxation	56,911,197
Less:	
Taxation	9,906,834
Net Profit	**47,004,363** ^

^ $5,222,707 + $47,004,363 = $52,227,070.

85. So the net profit after tax was actually $52,227,070. It is clear that when the accountant first calculated the net profit after tax, he did not include the SAB in the items of expenses. It was only after he had done that calculation and got the figure $52,227,070 that he then added the SAB in as an item of expenses.

86. Although the calculation was correct, the accounts did not follow the example given in Article 54(d). It was an artificial manipulation of the accounts in order to comply with the formula in Article 54(a), but at the same time make the SAB look like an item of expenditure.

87. Such a manipulation of the accounts was made necessary because the SAB was simply not an item of expenditure following the formula mandated in Article 54(a).

88. Before leaving the AFSs, we should mention one more thing. We cannot help but notice that the Appellant distributed all or most of its profits every year as SAB and dividends. See, for example, in 2000/01, its profit for the year was $67,276,540. This whole sum was distributed via SAB and several dividend and cash bonus distributions. In 2005/06, the dividends was $47,025,000 (just a few dollars' difference from $47,004,363).

89. With such a generous dividend distribution, to aver that the Operational Shareholders would not have 'remained in the business' or referred their family and friends to the Appellant when the time came, or would have diverted business elsewhere without the SAB is hardly convincing.

The 2013 Amendment to Articles 54 and 55

90. If the SAB scheme were in truth a scheme to reward the SAB Recipients for their services in the production of profits, then when the Appellant decided to amend the two Articles in 2013, it could and would have replaced it by proper service contracts or employment agreements setting out all relevant terms and conditions.

91. In particular, by 2013, the Appellant knew full well what the Assessor's objections were. Proper service contracts or employment agreements would have removed all the objections.

92. Instead the scheme was replaced by the issue of preference shares. This was another significant indication that the whole scheme from start to finish was intended to be a distribution of preferential dividends.

Remaining Grounds of the Grounds of Appeal

93. Ground 3 of the Grounds of Appeal complained that the Commissioner erred in failing to give weight to the annual Employer's Returns of Remuneration and Pensions and Notifications of Remuneration Paid to Persons Other than Employees in respect of the SAB Recipients wherein the SAB was reported as 'income accruing'.

94. We accept that the Employers' Returns and Notifications were relevant and tended to support the Appellant's claim that it believed that the SAB was a bonus subject to tax in the hands of the SAB Recipients, but this lone factor was not sufficient to go against the weight of the evidence.

95. As to the argument that it would amount to double taxation, that argument was not repeated in the submission, and quite rightly. Double taxation has no place in the present consideration.

96. Ground 4 of the Grounds of Appeal argued that the Revenue was self-contradictory in accepting the SAB as deductible from 1991 to 2000/01. This argument was very much misguided. The duty is on the taxpayer to faithfully and honestly report his tax liability and not to mislead or deceive. If an item is queried, it is no answer to say that

because the Assessor had been successfully misled before, he cannot now challenge the offending item.

Conclusion

97. We repeat paragraphs 29 and 30 above. We find that the SABs were not incurred 'in the production of profits' or 'expended for the purpose of producing such profits.' They were not deductible under sections 16 or 17 of the IRO.

98. Further and alternatively, the Appellant has fallen far short of its burden of proof under section 68(4) of the IRO.

99. We dismiss the appeal, and under section 68(8) of the IRO we confirm the Additional Profits Tax Assessments and Profits Tax Assessment as set out in paragraph 2 of the Determination.

Costs

100. Under section 68(9) and Part 1 of Schedule 5 of the IRO, the Board may order the Appellant to pay as costs of the Board a sum not exceeding $25,000.

101. This appeal has little merit. We consider it appropriate in the circumstances to order the Appellant to pay the maximum costs of $25,000 which shall be added to the tax charged and recovered therewith.

102. It remains for us to thank Counsel on both sides for their assistance.

Appendix One

Company A

AT AN EXTRAORDINARY GENERAL MEETING of Company A held on Sunday, the 27th day of January 1991 at Address AB, the following resolutions were passed as SPECIAL RESOLUTIONS:

(1) That the sub-title 'PROMOTORS' on Page 27 of the Memorandum & Articles of Association of the Company (hereinafter called 'M & A') be deleted and substituted therefor:

'SPECIAL ANNUAL BONUS'

(2) That Article 54 be deleted and substituted therefor by new Articles 54(a), 54(b), 54(c), 54(d), 54(e) and 54(f).

(3) That Article 55 be deleted and substituted therefor by new Articles 55(a), 55(b), 55(c), and 55(d).

(4) That details of the above amendments be adopted as follows:

'SPECIAL ANNUAL BONUS'

54.(a) A sum equivalent to 10% of the net profit of the Company in every fiscal year, after the profit/corporation tax of the Company, but before the distribution of dividends to the Shareholders, shall be alloted to those persons mentioned in Appendix ONE hereto annexed (hereinafter called 'The Entitlement Members') as Special Annual Bonus in the proportion/ratio (hereinafter called 'the Entitlement') as set out in the opposite column to the respective names.

54.(b) The word 'persons' mentioned in the preceding 54.(a) shall mean and include any person who has come of age in accordance with the Law of Hong Kong and also any incorporation or corporated body.

54.(c) The Special Annual Bonus provided herein shall be of a permanent nature during the life of the Company.

54.(d) For the avoidance of doubt, an example is given below for the calculation of the Special Annual Bonus derived from the net profit as follows:

Gross Profit for the year, say	$5,000,000.00
Less: Operation and Management Expenses etc., say	$2,000,000.00
	$3,000,000.00
Less: Profits Tax (Corporation Tax) for the year, say:	- $ 500,000.00
	$2,500,000.00
10% Special Annual Bonus thereon	$ 250,000.00

R% = Tax Rate
X = Taxation
Y = Special Annual Bonus

X = R% (Profit Before Taxation – Y ± Tax Compution Adjustment)
Y = 10% (Profit Before Taxation – X)

54.(e) The beneficiaries, heirs, administrators, executors assigns and/or successors in title of the Entitlement Member(s) shall be entitled to the Special Annual Bonus in the event of the death of the relevant Entitlement Member(s) in the same proportion/ratio of the relevant deceased.

54.(f) The relevant and necessary grant of Probate/Letters of Administration in respect of the estate must be obtained from the relevant Probate Authorities of Hong Kong and produced to the Board of Executive Directors.

55.(a) Subject to the written approval of the Board of Executive Directors of the Company, any Entitlement Member may transfer his/her/its/their entitlement to other person(s) or corporation (hereinafter called 'the Transferee') by submitting to the Board of Executive Directors a one month's prior notice in writing in the prescribed form as stipulated by the Company of his/her/its/their intention so to do.

55.(b) In the event of any Transferee of an Entitlement Member intending to transfer further the entitlement to any other person(s), the Transferee may, subject to the written approval of the Board of Executive Directors, apply to the Board of Executive Directors by submitting a one month's prior written 'Notice of Intention to Transfer' in the prescribed form stating the relevant grounds for such intended transfer for the consideration and approval of the Executive Directors.

55.(c) The Board of Executive Directors shall have the absolute

discretion in granting or refusing any transfer of intended transfer without assigning any reason therefor.

55.(d) The Board of Executive Directors shall have the absolute discretion in abridging the time for the notice/application for transfer.

Dated this 27th day of January 1991

(signed)
CHAIRMAN

Appendix Two

The Entitlement Member	Recipient	SAB Ratio %	Years involved
Mr C	Company X2	25.95	2000/01 to 2003/04
	Madam L	25.95	2004/05 to 2011/12
Mr E and Mr F	Company G	25.95	2000/01 to 2011/12
Mr AC	Company AD	17.29	2000/01 to 2011/12
Mr AE	Company AF	9.31	2000/01 to 2011/12
Mr AG	Company AH	3.73	2000/01 to 2003/04
	Mr AG	3.73	2004/05 to 2011/12
Mr AJ	Company AK	1.86	2000/01 to 2011/12
Mr AL	Company AM	1.86	2000/01 to 2011/12
Mr T	Mr T	1.86	2000/01 to 2011/12
Mr AN	Mr AP	1.86	2000/01 to 2011/12
Mr W	Madam V4	1.86	2000/01 to 2011/12
Mr AQ	Company U1	1.86	2000/01 to 2011/12
Mr AR	Company V2	1.86	2000/01 to 2011/12
Mr AS	Mr AS	0.93	2000/01
	Mr AT	0.93	2001/02 to 2002/03
	Mr V3	0.93	2003/04 to 2011/12
Mr AU	Mr S	0.93	2000/01 to 2011/12
Madam AV	Company AW	0.93	2000/01 to 2011/12
Mr AX	Company V1	0.55	2000/01 to 2011/12
Mr D	Mr U3	0.47	2000/01 to 2011/12
Mr K	Mr K	0.47	2000/01 to 2003/04
	Madam H	0.47	2004/05 to 2011/12
Mr AY	Mr AY	0.47	2000/01 to 2005/06
	Company U2	0.47	2006/07 to 2011/12

Company A
Transfer and succession of SAB recipients

Recipient named in the 1991 Special Resolutions	Transferee and subsequent transferee	Application date	Approved date
Mr C	Company X1	29-03-1991	04-04-1991
	Mr C	08-07-1992	09-07-1992
	Company X2	10-11-1994	11-11-1994
	Madam L	09-07-2004	12-07-2004
Mr F	Company G	25-02-1991	04-04-1991
Mr E	Company G	25-02-1991	04-04-1991
Mr AC	Company AD	02-03-1991	04-04-1991
Mr AE	Company AF	11-12-1991	13-12-1991

Recipient named in the 1991 Special Resolutions	Transferee and subsequent transferee	Application date	Approved date
Mr AG	Company AH	11-12-1996	18-12-1996
	Mr AG	05-06-2004	09-06-2004
Mr AJ	Company AK	03-07-1995	10-07-1995
Mr AL (alias AL1)	Company AM	03-07-1996	04-07-1996
Mr AN	Mr AZ and Mr AP	04-07-1991	15-07-1991
Mr W	Madam V4 (Administratrix)	Note 1	13-02-1998
Mr AQ	Company U1	13-08-1999	16-08-1999
Mr AR	Company V2	27-09-1996	03-10-1996
Mr AS	Mr AT	21-08-2001	31-08-2001
	Mr V3	12-07-2002	17-07-2002
Mr AU	Mr S	16-03-1992	20-03-1992
Madam AV	Company AW	31-03-1991	04-04-1991
Mr AX	Company V1	07-05-1997	08-05-1997
Mr D	Mr U4 and Mr U3 (Executors)	Note 2	N/A
	Mr U3	06-06-1993	N/A
Mr K	Madam H	28-05-2004	10-06-2004
Mr AY	Company U2	08-05-2006	12-06-2006

Note 1: Probate jurisdiction dated 27 April 1995
Note 2: Probate jurisdiction dated 31 December 1992
N/A: Not available