

Case No. D4/14

Profits tax – expenses – whether bona fide incurred in the production of chargeable profits – whether sole or dominant purpose to obtain a tax benefit – late amendment to grounds of appeal – sections 16, 61A, 66(3) and 68(4) of the Inland Revenue Ordinance ('IRO').

Panel: Kenneth Kwok Hing Wai SC (chairman), Liu Man Kin and Lo Pui Yin.

Dates of hearing: 8 and 9 December 2011.

Date of decision: 28 April 2014.

The Taxpayer objects to the Additional Profits Tax Assessments for the years of assessment 1999/00 to 2004/05 and the Profits Tax Assessments for the years of assessment 2005/06 to 2007/08.

The Taxpayer contends that sales commission or directors' emolument, bonus to Mr B (the Chairman of the Taxpayer) and his family members and sales commission to Country H Corporations (Company M, Company N and Company P) should be allowable for deduction.

The Deputy Commissioner concluded that the expenses in dispute were not bona fide incurred by the Taxpayer in the production of its chargeable profits.

The Deputy Commissioner further invoked section 61A and concluded that the Taxpayer together with the Country H Corporations, Mr B and his family members had entered into the charging transactions for the sole or dominant purpose of enabling the Taxpayer to obtain a tax benefit.

The Taxpayer appeals.

At the end of the hearing, the Taxpayer applied to amend its grounds of appeal.

Held:

1. This Board declines to give consent under section 66(3) of IRO as the proposed amended ground of appeal discloses no arguable ground of appeal.
2. The Taxpayer bears the burden of showing that the assessments are wrong.

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

- 2.1 The Taxpayer is not entitled to benefit by choosing not to call Mr B and 3 of his sons, Mr C, Mr F and Mr D. This Board therefore attaches no weight to the contents of their witness statements.
 - 2.2 The Taxpayer has not called any of its accounting staff, auditor or the auditor's staff to explain its accounts and financial statements.
 - 2.3 The evidence of Mr AA (the General Manager) and Ms Z (who handled project development of the Taxpayer) could not assist this Board.
 - 2.4 There is no documentation which records the duties of Mr B's family members in the Taxpayer and the terms of remuneration for discharging such duties.
 - 2.5 There is also no documentation which records or set out how the remuneration now said to have been incurred were calculated.
 - 2.6 Yet, there is documentation which indicates that Mr C, Mr D, Mr F and Mr E held no position in the organization of the Taxpayer.
 - 2.7 Mr B's account on sales rebates to Company M, Company N and Company P, each owned by one of his sons suggests more of a familial decision by a patriarch than a commercial decision by an experienced businessman.
 - 2.8 There have been materially different versions of the expenses in dispute yet the Taxpayer fails to explain how those facts came to have been made.
3. The Taxpayer has not discharged its burden under section 68(4) of IRO.
 4. None of the sums in dispute was incurred for the purpose alleged by the Taxpayer and none of the sums in dispute was incurred in the production of the Taxpayer's profits.
 5. As none of the expenses in dispute is deductible, there is no tax benefit and section 61A of IRO does not apply.

Appeal dismissed.

Cases referred to:

China Map Ltd v Commissioner of Inland Revenue (2008) 11 HKCFAR 486
CIR v Lo & Lo [1984] HKC 220

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

D7/11, (2011-12) IRBRD, vol 26, 93
Shui On Credit Company Limited v Commissioner of Inland Revenue (2009) 12 HKCFAR 392
Lee Yee Shing Jacky and another v Board of Review (Inland Revenue Ordinance) and another [2012] 2 HKLRD 981
Kim Eng Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 10 HKCFAR 213
Wing Tai Development Co Ltd v Commissioner of Inland Revenue [1979] HKLR 642
Li Sau Keung v Maxcredit Engineering Ltd & Anor [2004] 1 HKC 434
Chinachem Investment Co Ltd v Commissioner of Inland Revenue (1987) 2 HKTC 261
Real Estate Investment (NT) Ltd v Commissioner of Inland Revenue (2008) 11 HKCFAR 433
Nice Cheer Investment v Commissioner of Inland Revenue [2011] 5 HKC 169
Re Ocean Time Development Ltd (HCCW 334/2004)
So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416
D94/99, IRBRD, vol 14, 603

Paul Carolan instructed by Weir & Associates for the Appellant.

Paul Leung instructed by Department of Justice for the Commissioner of Inland Revenue.

Decision:

Introduction

1. Company A, a company incorporated in Hong Kong ('the Taxpayer'), appeals against the Determination dated 23 March 2011 by the Deputy Commissioner of Inland Revenue rejecting the Taxpayer's objection to the Additional Profits Tax Assessments for the years of assessment 1999/00 to 2004/05 and the Profits Tax Assessments for the years of assessment 2005/06 to 2007/08 ('the Deputy Commissioner's Determination').

2. The Taxpayer's appeal before this Board is concerned with the question of whether certain sums are allowable for deduction for the purpose of calculating the Taxpayer's assessable profits. They include payments or credit made to 5 persons who are its directors and/or shareholders and sums paid or credited to 4 Country H corporations. The other issues raised in this appeal are whether the tax avoidance provisions of section 61 or section 61A of the Inland Revenue Ordinance (Chapter 112) apply in this case.

Statement of Agreed Facts

3. The legal representatives of the Taxpayer and the Revenue have agreed on a Statement of Agreed Facts for the purpose of the hearing before this Board. The Statement of Agreed Facts is reproduced below and this Board finds the agreed facts as facts:

- (1) [The Taxpayer] has objected to the additional Profits Tax assessments for the years of assessment 1999/00 to 2004/05 and the Profits Tax assessments for the years of assessment 2005/06 to 2007/08 raised on it. [The Taxpayer] claims that certain expenses should be allowable for deduction in arriving at the assessable profits.
- (2) (a) [The Taxpayer] was incorporated as a private limited company in Hong Kong [in] April 1992. At all relevant times, its authorized and issued share capital was \$200,000, divided into 200,000 ordinary shares of \$1 each. The ordinary shares are classified as ‘A’ shares and non-voting ‘B’ shares. [The Taxpayer’s] shareholders were:

<u>Shareholders</u>	<u>Class of shares</u>	
	<u>‘A’</u>	<u>Non-voting ‘B’</u>
	\$	\$
[Mr B]	34,000	35,000
[Mr C]	33,000	
[Mr D]	33,000	20,000
[Mr E]		20,000
[Mr F]		20,000
[Mr G]		5,000
	<hr/>	<hr/>
	100,000	100,000

Note: [Mr B] is the father of [Mr C], [Mr D], [Mr E] and [Mr F]. They all reside in [Country H].

- (b) [Mr B], [Mr C] and [Mr D] were [the Taxpayer’s] directors.
 - (c) At all relevant times, [the Taxpayer’s] registered office was located at [Address J] and its business address was [Address K].
 - (d) The principal activity of [the Taxpayer] was general trading as stated in its reports of the directors.
 - (e) [The Taxpayer] closed its accounts annually on 31 December.
- (3) At the relevant times [Mr B], [Mr C], [Mr D] and [Mr F] were the directors of [Company L], [Company M], [Company N] and

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

[Company P] respectively. All these companies were established under the laws of [State Q], [Country H] (collectively ‘the Country H Corporations’).

(4) On various dates, [the Taxpayer] filed its Profits Tax returns for the years of assessment 1999/00 to 2007/08 together with audited financial statements and tax computations.

(a) In its Profits Tax returns, [the Taxpayer] declared the following assessable profits and adjusted loss:

Yr of assessment	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	\$	\$	\$	\$	\$	\$	\$	\$	\$
Assessable Profits/ (Adjusted Loss)	(32,125)	398,957	906,659	1,206,931	1,737,359	5,107,345	(1,194,672)	(1,125,631)	3,787,555

(b) The detailed profit and loss accounts of [the Taxpayer] showed the following particulars:

Yr of assessment	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	\$	\$	\$	\$	\$	\$	\$	\$	\$
Sales	59,181,542	75,783,198	116,745,010	272,865,640	433,734,796	441,361,367	343,694,678	267,399,561	409,581,252
Less: Cost of Sales	<u>54,244,921</u>	<u>69,394,725</u>	<u>109,033,611</u>	<u>251,844,804</u>	<u>405,698,295</u>	<u>413,405,818</u>	<u>324,040,905</u>	<u>251,858,396</u>	<u>385,020,212</u>
Gross profit	4,936,621	7,711,399	6,388,473	21,020,836	28,036,501	27,955,549	19,653,773	15,541,165	24,561,040
Add: Other income	<u>343,655</u>	<u>476,289</u>	<u>867,558</u>	<u>1,006,639</u>	<u>478,466</u>	<u>423,734</u>	<u>251,513</u>	<u>650,910</u>	<u>871,620</u>
	5,280,276	6,864,762	8,578,957	22,027,475	28,514,967	28,379,283	19,905,286	16,192,075	25,432,660
Less: Expenses									
Salaries & allowances	1,492,394	1,857,180	2,464,019	3,491,472	3,101,638	3,526,838	3,430,472	2,547,826	3,216,683
Sales commission	706,298	104,213	144,006	6,474,217	5,669,102	3,857,782	4,831,161	6,223,767	8,319,773
Directors' emolument	601,127	1,090,690	1,757,625	4,818,750	3,377,487	4,070,256	4,659,670	4,230,636	5,525,593
Other expenses	<u>2,459,436</u>	<u>3,294,446</u>	<u>3,244,920</u>	<u>6,121,290</u>	<u>14,624,637</u>	<u>11,754,605</u>	<u>8,369,407</u>	<u>4,251,009</u>	<u>4,680,518</u>
	5,259,255	6,346,529	7,610,570	20,905,729	26,722,864	23,209,481	21,290,710	17,253,238	21,742,567
Profit/(Loss) before tax	<u>21,021</u>	<u>518,233</u>	<u>968,387</u>	<u>1,121,746</u>	<u>1,742,103</u>	<u>5,169,802</u>	<u>(1,385,424)</u>	<u>(1,061,163)</u>	<u>3,690,093</u>

Note: The detailed profit and loss accounts of [the Taxpayer] for the years ended 31 December 1999 to 2007 are at Appendix A of the Determination

(c) The balance sheets of [the Taxpayer] showed the following particulars:

Yr of assessment	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	\$	\$	\$	\$	\$	\$	\$	\$	\$
<u>Non-current assets</u>									
Land and building	0	0	0	0	4,223,156	4,136,969	4,050,783	3,964,595	3,878,409
Furniture and fixtures	1,353	755	9,302	0	66,235	54,317	42,386	96,991	70,979
Leasehold improvement	<u>39,762</u>	<u>66,335</u>	<u>74,670</u>	<u>0</u>	<u>194,126</u>	<u>148,874</u>	<u>99,523</u>	<u>50,171</u>	<u>820</u>
	<u>41,115</u>	<u>67,090</u>	<u>83,972</u>	<u>0</u>	<u>4,483,517</u>	<u>4,340,160</u>	<u>4,192,692</u>	<u>4,111,757</u>	<u>3,950,208</u>
<u>Current assets</u>									
Trade debtors and Bills receivable	877,576	3,825,172	3,899,050	14,072,446	62,933,638	68,509,878	62,239,794	1,189,065	9,860,436
Other debtors, deposits, and pre-payment	462,634	568,792	357,094	2,482,670	2,537,726	14,837,616	15,562,316	20,585,334	23,793,611
Cash & bank	5,145,358	3,388,779	7,913,032	20,839,051	11,370,479	7,249,616	17,457,006	17,266,311	20,860,160
Amount due from a related company	0	0	0	0	0	0	0	41,892,922	60,745,751
Tax prepaid	<u>139,476</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>893,785</u>	<u>893,785</u>	<u>1,005,016</u>
	<u>6,625,044</u>	<u>7,782,743</u>	<u>12,169,176</u>	<u>37,394,167</u>	<u>76,841,843</u>	<u>90,957,110</u>	<u>96,152,901</u>	<u>81,827,417</u>	<u>116,264,974</u>
<u>Current liabilities</u>									
Trade creditors and bills payable	577,367	2,000,852	2,067,556	8,930,583	30,518,314	21,502,380	11,354,245	14,968,995	36,312,148

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

Yr of assessment	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	\$	\$	\$	\$	\$	\$	\$	\$	\$
Other creditors and accrued expenses	442,851	1,009,565	636,363	7,392,596	24,212,722	37,921,081	47,263,983	22,836,211	23,822,053
Amount due to related companies	0	0	0	840,547	1,234,638	2,113,123	5,007,060	6,493,192	9,184,069
Provision for taxation	0	58,693	81,232	48,043	93,046	590,081	0	0	0
Bank mortgage loan	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>292,800</u>	<u>292,800</u>	<u>292,800</u>	<u>292,800</u>	<u>292,800</u>
	<u>1,020,218</u>	<u>3,069,110</u>	<u>2,785,151</u>	<u>17,211,769</u>	<u>56,351,520</u>	<u>62,419,465</u>	<u>63,918,088</u>	<u>44,591,198</u>	<u>69,611,070</u>
<u>Non-current liabilities</u>									
Bank mortgage loan	0	0	0	0	2,438,000	2,145,200	1,852,400	1,559,600	1,266,800
Amount due to Shareholders	<u>3,242,290</u>	<u>1,917,532</u>	<u>5,781,484</u>	<u>15,567,248</u>	<u>16,482,845</u>	<u>20,043,775</u>	<u>25,631,331</u>	<u>31,905,765</u>	<u>38,021,377</u>
	3,342,290	1,917,532	5,781,484	15,567,248	18,920,248	22,188,975	27,483,731	33,465,365	39,288,177
Total net assets	<u>2,403,651</u>	<u>2,863,191</u>	<u>3,686,513</u>	<u>4,615,150</u>	<u>6,052,995</u>	<u>10,328,830</u>	<u>8,943,774</u>	<u>7,882,611</u>	<u>11,315,935</u>
<u>Financed by:</u>									
Share capital	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000
Share premium	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000
Retained profits	<u>1,803,651</u>	<u>2,263,191</u>	<u>3,086,513</u>	<u>4,015,150</u>	<u>5,452,995</u>	<u>9,728,830</u>	<u>8,343,774</u>	<u>7,282,611</u>	<u>10,715,935</u>
	<u>2,403,651</u>	<u>2,863,191</u>	<u>3,686,513</u>	<u>4,615,150</u>	<u>6,052,995</u>	<u>10,328,830</u>	<u>8,943,774</u>	<u>7,882,611</u>	<u>11,315,935</u>

- (5) On various dates, the Assessor issued to [the Taxpayer] a statement of loss of the year of assessment 1999/00 and Profits Tax Assessments for the years of assessment 2000/01 to 2004/05 in accordance with the returned adjusted loss and assessable profits as per Fact (4)(a). No objection was lodged by [the Taxpayer].
- (6) In response to the Assessor's enquiries, [Company R] ('the Former Representatives'), on behalf of [the Taxpayer], asserted the following in relation to [the Taxpayer's] accounts for the years of assessment 2002/03 and 2005/06:

In relation to sales commission

- (a) The recipients [Mr E], [Mr F] and the Country H Corporations, were remunerated for their contribution mainly including soliciting the customers and following up the sale orders.
- (b) Basis of calculation of the commission for the year of assessment 2002/03 varied from deal to deal (for example, based on certain amount per unit sold or certain percentage of gross profit). On the other hand, the commission for the year of assessment 2005/06 was decided by negotiation.
- (c) Commission was paid through banks or the recipients' current accounts with [the Taxpayer].

In relation to directors' emolument

- (d) The breakdown of the directors' emolument for the year of assessment 2002/03 was as follows:

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

<u>Name of director</u>	<u>Salary</u>	<u>Offshore consultancy fee</u>	<u>Offshore commission</u>	<u>Offshore performance bonus</u>	<u>Total</u>
	\$	\$	\$	\$	\$
[Mr B]	100,000	300,000 ⁽²⁾	970,330	800,000	2,170,030
[Mr C]	100,000 ⁽¹⁾	-	170,822	800,000	1,070,822
[Mr D]	100,000 ⁽¹⁾	-	677,598	800,000	1,577,598
	<u>300,000</u>	<u>300,000</u>	<u>1,878,750</u>	<u>2,400,000</u>	<u>4,818,750</u>

Note:

(1) According to the audit working papers provided by the Former Representatives as [the Taxpayer's] auditors, the alleged salary of [Mr C] and [Mr D] in the respective amounts of \$100,000 were credited to the director's current account of [Mr B] by a year-end entry.

(2) Annual remuneration of \$300,000 to [Mr B].

(e) 'For salary payment, the directors were remunerated for the management of Hong Kong office.'

(f) 'For offshore consultancy fee, offshore commission and offshore performance bonus, the directors were remunerated for the following services carrying (*sic*) outside Hong Kong:

- Analysing and searching business opportunities in [Country H].
- Designing marketing strategies in [Country H].
- Analysing the marketing environment in [Country H].
- Analysing consumer markets and buyer behaviour in [Country H].
- Analysing and identifying [the Taxpayer's] competitors in [Country H].
- Assessing the competitors' strengths and weaknesses in [Country H].
- Forecasting market demand and potentials in [Country H].
- Evaluating and selecting the market segments in [Country H].
- Designing pricing strategies.
- Negotiating the terms and conditions of the orders with customers in [Country H].
- Soliciting the customers in [Country H].'

(g) The basis of calculation of the directors' emolument was decided by the members in the extraordinary general meeting on 31 December 2002. The Former Representatives provided a copy of the meeting minutes.

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (h) 'Offshore commission was based on certain sales to customers in [Country H]'.
 - (i) 'Offshore bonus was based on the result of the [the Taxpayer's] performance in [Country H]'.
 - (j) 'Salary was paid through bank ... Other payments were made through the current accounts of directors.'
- (7) In mid-2006, the Assessor commenced an investigation into the tax affairs of [the Taxpayer].
- (8) Concerning salaries and allowances, sales commission and directors' emolument charged in [the Taxpayer's] accounts, the Former Representatives and [the Taxpayer] asserted, among other things, the following:
 - (a) 'Directors act in the capacity of sales managers, provide services by sending [the Taxpayer] the orders from their offices in [Country H].'
 - (b) There are no service contracts/agreements signed between [the Taxpayer] and the directors regarding terms of employment plus details of services rendered by the directors.
 - (c) The salaries and allowances paid to [Mr F] and [Mr E] were offshore bonus. They acted in the capacity of sales managers, generated sales in [Country H], solicited customers and sent purchase orders to [the Taxpayer].
 - (d) [The Taxpayer] credited the directors' emolument, sales commission and offshore bonus to the recipients' accounts in its books and would send fund to the recipients whenever they required.
 - (e) The basis of computation of directors' emolument, sales commission and offshore bonus was ultimately decided by [Mr B], the chairman of [the Taxpayer], verbally through the meeting.
 - (f) [Company L] was the largest customer of [the Taxpayer]. [The Taxpayer] had the following amounts of sales to [Company L] for the relevant years:

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

Year of assessment	<u>2000/01</u>	<u>2001/02</u>	<u>2002/03</u>	<u>2003/04</u>	<u>2004/05</u>	<u>2005/06</u>	<u>2006/07</u>	<u>2007/08</u>
	\$	\$	\$	\$	\$	\$	\$	\$
Sales to [Company L]	44,092,003	98,794,216	236,884,081	397,035,197	416,572,066	324,795,815	256,423,374	384,812,593
Total sales*	75,783,198	116,745,010	272,865,640	433,734,796	441,361,367	343,694,678	267,399,561	409,581,252

* Extracted from [the Taxpayers's] detailed profit and loss accounts for comparison purpose [see Fact (4)(b)].

(9) The Former Representatives and [the Taxpayer] also supplied a breakdown of the expenses in question as follows:

Yr of assessment	<u>1999/00</u>	<u>2000/01</u>	<u>2001/02</u>	<u>2002/03</u>	<u>2003/04</u>	<u>2004/05</u>	<u>2005/06</u>	<u>2006/07</u>	<u>2007/08</u>
	\$	\$	\$	\$	\$	\$	\$	\$	\$
<u>Salaries and allowances Recipients</u>									
[Mr F]	0	200,000	400,000	990,678	600,000	700,000	708,525	300,000	508,525
[Mr E]	0	200,000	400,000	900,000	600,000	700,000	708,525	300,000	508,525
	<u>0</u>	<u>400,000</u>	<u>800,000</u>	<u>1,890,678</u>	<u>1,200,000</u>	<u>1,400,000</u>	<u>1,417,050</u>	<u>600,000</u>	<u>1,017,050</u>
<u>Directors' emolument Recipients</u>									
[Mr B]	548,381	630,121	836,569	2,370,330	1,300,910	1,611,334	1,900,528	1,957,734	2,548,160
[Mr C]	36,662	250,227	476,412	970,822	784,471	939,900	1,055,962	773,239	1,080,410
[Mr D]	16,084	210,342	444,644	1,477,598	1,292,106	1,519,022	1,703,180	1,499,663	1,897,023
	<u>601,127</u>	<u>1,090,690</u>	<u>1,757,625</u>	<u>4,818,750</u>	<u>3,377,487</u>	<u>4,070,256</u>	<u>4,659,670</u>	<u>4,230,636</u>	<u>5,525,593</u>
<u>Sales commission Recipients</u>									
[Mr F]	628,612	66,423	95,112	368,767	410,246	359,699	306,282	338,122	312,782
[Mr E]	5,993	10,783	48,894	134,770	64,032	15,397	60,289	69,017	102,567
[Company N]	69,025	27,007	0	656,518	37,741	137,730	400,237	357,643	486,448
[Company P]	0	0	0	5,314,148	3,803,953	1,001,712	1,068,620	1,207,238	1,368,823
[Company M]	0	0	0	14	892,373	61,665	198,047	394,645	498,710
[Company L]	0	0	0	0	460,757	2,273,293	2,797,596	3,853,111	4,905,702
[Ms S]	0	0	0	0	0	0	0	0	635,751
	<u>703,630</u>	<u>104,213</u>	<u>144,006</u>	<u>6,474,217</u>	<u>5,669,102</u>	<u>3,849,496</u>	<u>4,831,161</u>	<u>6,219,776</u>	<u>8,310,783</u>

Note: [Ms S] is the wife of [Mr B].

(10) In the course of the investigation, the Assessor raised on [the Taxpayer] the following additional Profits Tax Assessments for the years of assessment 1999/00 to 2002/03:

<u>Year of assessment</u>	<u>Additional Assessable Profits</u>	<u>Tax Payable thereon</u>
	\$	\$
1999/00	1,500,000	240,000
2000/01	4,000,000	640,000
2001/02	4,000,000	640,000
2002/03	15,000,000	2,400,000

(11) [The Taxpayer], through the Former Representatives, objected to the above Additional Profits Tax Assessments on the ground that the assessments were excessive.

(12) By a letter dated 27 February 2009, [the Taxpayer] appointed [Company T] ('the New Representative') as its tax representative.

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (13) On 2 April 2009, [Mr B] and [Mr U] of the New Representative attended an interview with the Assessors. By letters dated 6 April 2009 and 4 May 2009, the New Representative, on behalf of [the Taxpayer], confirmed that the following information was provided to the Assessors during the interview:

[The Taxpayer]

- (a) [Mr B] had been doing business in Hong Kong, Taiwan and China since the 1960s using trading company suppliers or buying agents. As a natural progression he wanted to have his own buying office in the 1980s, but only in 1992 did he establish [the Taxpayer] and operate it as a separate legal entity to be his buying office with the intention it covered its overheads based on a gross profit margin of 5% and then perhaps with unrelated new customers made some profit. When [Mr B's] sons started selling household/ giftware products that were widely publicised on television in [Country H], he persuaded them to also use [the Taxpayer] as their buying office in Hong Kong and stop using agents and other middlemen.

The Country H Corporations

- (b) [Mr B] commenced the business of [Company L] as an importer and distributor in [Country H] in the 1960s. In 1985, [Company M] was established by [Mr C]. In 1993, [Mr D] started [Company N] and in 1999, [Mr F] started [Company P].
- (c) Sales rebates were provided to [Company M], [Company N] and [Company P] as an incentive to them for doing business with [the Taxpayer].
- (d) No sales rebate was given before 2002 because there was not enough volume or indeed profit to justify any rebate at all.
- (e) To secure [the Taxpayer's] credibility with suppliers, [Company L] financially guaranteed the credit of [Company M], [Company N] and [Company P], by having [the Taxpayer] invoiced [Company L] for all goods shipped directly to these three corporations. For this, Company L charged [the Taxpayer] a small fee (ranging over the years from less than 0.5 to 1.5%) based on turnover done with the three related [Country H] corporations but modified by [Mr B's] own assessment of the underlying credit risk undertaken by [Company L].

[Mr B] and his four sons

- (f) [Mr C], [Mr D] and [Mr F] (collectively 'the Three Sons') were required from time to time to wear more than one 'hat' as they undertook work in their capacity as employees of [the Taxpayer] to develop the products from conception and sourcing to shipment and then in their capacity as employees of the [Country H] Corporations to market, promote, and deliver the products to their domestic customers.
- (g) [The Taxpayer] had 14 employees and 16 QC (quality check) people employed in Mainland China. The [Mr B family] individually and collectively managed the business of [the Taxpayer] from [Country H]. While spending rather little time in Hong Kong, they spent a great deal of time on the telephone, email and fax. The Three Sons spend much of their time in Mainland China to work with factories there.
- (h) [Mr B] used the [Product M1] marketed by [Company M] to show how the Three Sons were involved in the whole business process. [Mr C] wore two hats, as product conceptualiser / developer / procurer / supply price negotiator for [the Taxpayer], and then as marketer / distributor / channel developer / advertising negotiator / price negotiator for [Company M]. He developed outlets for the products. He also worked with [the Taxpayer's] staff to find a factory in Asia for developing the prototype to be tested in [Country H]. He then put on [the Taxpayer's] 'hat' again and negotiated the FOB supply price, volume and shipping schedule with the factory before settling on the packaging requirements with another factory. In the event of delays or claims, [Mr C] would be responsible to negotiate and deal with them for [the Taxpayer]. His work in [the Taxpayer] required daily contact with his support staff in Hong Kong and often directly with the factory in Mainland China.
- (i) [Mr B] was consulted by all his sons in view of his considerable experience. His advice employed for the supply/ production end was paid for by the salary and bonus he received directly from [the Taxpayer].
- (j) [Mr E], while having his own business in [Country H] which did not have any business transactions with [the Taxpayer], was a general consultant to [the Taxpayer's] board. He did not relate to any specific products or transactions of [the Taxpayer]. As he

performed the service in [Country H], he did not come to Hong Kong so much. He did not come to Hong Kong in 2006 at all.

Nature and taxability of the expenses in dispute

- (k) Commissions to the [Country H] Corporations would be better classified as sales rebates to the three trading companies (i.e. [Company N], [Company P] and [Company M]) and a financial guarantee fee to [Company L].
 - (l) The sales rebates could have been rightly booked as a debit to sales and should not be treated as an expense item.
 - (m) The financial guarantee fee was earned in the jurisdiction of the debtor where the debt would have been situated in the event of a recovery action, and thus was not sourced in Hong Kong.
 - (n) In relation to the remuneration paid to [the Taxpayer's] directors, it included a fixed salary and a variable bonus based upon [Mr B's] judgment, taking into account the contribution of each person, the complexity of their contributions, their standing and seniority.
 - (o) None of the directors were remunerated for the services as directors. Since all the individuals spent less than 60 days in a year in Hong Kong, their remunerations were not chargeable to Salaries Tax.
- (14) In response to the Assessor's enquiries, the New Representative asserted the following:

In relation to [Company M], [Company N] and [Company P]

- (a) 'Sales Commissions' (or claimed as 'sales rebates' by the New Representative) to the corporations included 'customer referral sales commissions' paid in respect of sales of goods by [the Taxpayer] to third parties. The agreements to pay the commissions were not reduced to writing except to the extent that [the Taxpayer] issued credit notes to the relevant parties after the sales were made. The amounts of the commissions were usually based on so much per unit shipped.
- (b) The remaining commissions were 'sales rebates', which were paid to incentivise the aforesaid three corporations doing more business with [the Taxpayer]. The New Representative provided breakdowns of the 'sales rebates' and the volume of sales

generated by the three corporations for 2006 to support its claim. The breakdown are at Appendix C of the Determination.

- (c) ‘The basis of calculation of the “rebates” has ... always been by reference to a number of commercial factors weighted according to the commercial judgment of [Mr B].’

In relation to Company L

- (d) ‘[Mr B] settles [the sales commission to Company L] by reference to factors including *inter alia* volume, perceived risk for [Company L] (based on its own assessment of the market into which the other three corporations sell), the vulnerability of [the Taxpayer], the anticipated cash flow requirements of [the Taxpayer]. In the end it is agreed by [the Taxpayer] and effectively approved by the Board of Directors of both companies.
- (e) In respect of the sales commission to [Company L], [Mr B] could not recall why no fees were paid to this company before 2003.

In relation to [Mr B] and his four sons

- (f) ‘... the Directors are not in fact rewarded by [the Taxpayer] as “sales managers”. Their performance in many functions is rewarded by performance bonuses as well as the nominal bonuses given at festive times of the year. Further, and perhaps obviously their functions, for which they are remunerated, are for the material part performed outside Hong Kong ... The amounts are determined for proposal to the Board by [Mr B] and are implicitly approved by the Board and the only evidence of this approval is their annual approval of the audited financial statements for presentation to the shareholders at the AGM.’
- (g) The more correct terms for the salaries and allowances to [Mr F] and [Mr E] were ‘bonuses’ and ‘consulting fees’ respectively.
- (15) [The Taxpayer] confirmed that it did not keep any employment contracts, written minutes and other documents which set out the duties of [Mr B’s] family members and the payment terms in relation to the arrangements made between the family members and the related corporations. On divers dates, the New Representative put forth the following contentions:
- (a) ‘[It] was “form” rather than “substance” which was lacking.’

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (b) ‘While [Mr B] as the head of the family might have the “final word” on everything, in practice meetings were held frequently and decisions made daily and these were consultative and cooperative in the family spirit and that the salaries and consultancy fees were booked and the accounts approved formally by the board and the accounts signed, means they were not simply the “wiles” of only [Mr B] but the firm decisions of the Board.’
 - (c) ‘That this family saved money on legal fees to create the “form” cannot be a basis for denying the existence of the “substance” in the way they conduct business with each other in the group of family related enterprises ...’
 - (d) ‘[We] believe the substance is sufficiently documented and evidenced by the audited financial statements and their approval by the Board and the fact no one of the parties is in any dispute with [the Taxpayer] over the amount or payment of their dues.’
- (16) On 3 September 2009, [the Taxpayer] provided its general ledgers for the years ended 31 December 2000 to 2007 and accounting books and records for the year ended 31 December 2006 to the Assessor for examination. The Assessor made the following observations:
- (a) The account no. 1, which was named as ‘Sales commission paid’, recorded the monthly payment of \$25,000 to [Mr B] and also the commission payments to [Company N], [Company M] and [Company P]. The commission payments to the three corporations were related to sales to third parties. The payments were made through a bank.
 - (b) (i) The account no. 2, which was named as ‘Sales commission’, recorded sums that were charged at the end of each month for [Mr B], his four sons and [Country H] Corporations. The corresponding entries went to their respective current accounts. The account also showed that the sums charged for [Mr B], his four sons and [Country H] Corporations each month were of similar amounts for every particular year. The sums were charged for [Company N], [Company M] and [Company P] since December 2002 and that for [Company L] since September 2003. Besides, a sum was charged for [Ms S] in December 2007. A breakdown of the monthly sums charged through account no. 2 for the relevant years is at Appendix D of the Determination.

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (ii) It was also observed from the account no. 2 that the sums charged for the directors (i.e. [Mr B], [Mr C] and [Mr D]) were recorded as 'Directors' emolument', and the sums charged for the other related parties (i.e. [Mr F], [Mr E], [Ms S] and the [Country H] Corporations) were recorded as 'Sales commission' in [the Taxpayer's] audited accounts.
- (c) (i) The account no. 3, which was named as 'Bonus to shareholders and staff', recorded bonus of fixed sums that were charged for [Mr B] and his four sons at festival times. The same amount was charged for each of them at each time. The corresponding entries went to their respective current accounts. The amounts charged for each of them for the relevant years were as follows:

<u>Year of assessment</u>	<u>Amount of bonus charged for each person (\$)</u>
1999/00	0
2000/01	200,000
2001/02	400,000
2002/03	800,000
2003/04	600,000
2004/05	700,000
2005/06	700,000
2006/07	300,000
2007/08	500,000

- (ii) The sums which were charged for [Mr B], [Mr C] and [Mr D] were recorded as 'Directors' emolument', whereas those for [Mr F] and [Mr E] were recorded as 'Salaries and allowances' in the audited accounts.
- (d) A sum of \$8,525 (described as 'Bonus for Diwali') in the general ledgers) were paid to each of [Mr B] and his four sons, as well as [Ms S], [Ms V], [Ms W], [Ms X] and [Ms Y] (the wives of [Mr B] and his four sons) for each year. The bonus was charged either as directors' emolument, salaries and allowances or entertainment expenses in [the Taxpayer's] accounts. The payments were made through a bank.
- (e) On 30 June 2002 (during the basis period for the year of assessment 2002/03), the current account of [Mr B] and his four sons were credited with an entry named as 'ADJ of balance per cash flow' (Adjustment of balance per cash flow). The total amount involved was \$1,209,347. The breakdown for each individual is as follows:

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

<u>Individual</u>	<u>Amount of ADJ of balance per cash flow (\$)</u>
[Mr B]	734,435
[Mr C]	5,044
[Mr D]	179,190
[Mr F]	190,678
[Mr E]	<u>100,000</u>
	1,209,347
	=====

In the case of [Mr B], [Mr C] and [Mr D], the respective amounts (i.e. \$734,435, \$5,044 and \$179,190) were included in 'Directors' emolument'. In the case of [Mr F] and [Mr E], the respective amounts (i.e. \$190,678 and \$100,000) were included in 'Salaries and allowances'.

(f) The outstanding amount at the current account of each related party was growing during the relevant years, as payments were only made to the related parties occasionally.

(17) In response to the Assessor's requests, the Former Representatives, in their capacity as [the Taxpayer's] auditors, provided to the Assessor audit working papers in relation to the preparation of [the Taxpayer's] financial statements for the years of assessment 1999/00 to 2007/08.

(18) The Assessor raised on [the Taxpayer] the following Additional Profits Tax Assessments for the years of assessment 2003/04 and 2004/05 and Profits Tax Assessments for the years of assessment 2005/06 to 2007/08:

Year of assessment	<u>1999/00</u>	<u>2000/01</u>	<u>2001/02</u>	<u>2002/03</u>	<u>2003/04</u>
	\$	\$	\$	\$	\$
Profit/Loss per return [Fact (4)(a)]	1,737,559	5,107,345	(1,194,672)	(1,125,631)	3,787,555
<u>Add:</u> Loan interest to individuals*	1,751,765	2,053,638	2,607,329	3,437,775	4,756,732
Loan interest to the Country H Corporations*	1,421,470	3,474,400	4,339,590	5,807,216	7,259,683
Bonus to directors and shareholders	3,042,625	3,542,625	3,542,625	1,542,625	2,542,625
Bonus to wives of directors and shareholders	<u>42,625</u>	<u>42,625</u>	<u>42,625</u>	<u>42,625</u>	<u>42,625</u>
Adjusted Assessable Profits/ Assessable Profits	7,996,044	14,220,633	<u>9,337,497</u>	<u>9,704,610</u>	<u>18,389,220</u>
<u>Less:</u> Profits already assessed	<u>1,737,559</u>	<u>5,107,345</u>			
Additional Assessable Profits	6,258,485	9,113,288			
Tax Payable thereon	<u>1,095,235</u>	<u>1,594,825</u>	<u>1,634,061</u>	<u>1,698,306</u>	<u>3,193,113</u>

*i.e. Sums charged through the account no. 2 (breakdowns as per Appendix D of the Determination)

Assessor's Note:

This additional assessment/ assessment is raised to disallow expenses that are not deductible under section 16(1) and section 17(1)(b) of the Ordinance.

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

Note

The breakdown of the disallowed expenses is as follows:

Items	Individual/ Corporation	Included in [the Taxpayer's] accounts as:	<u>2003/04</u> \$	<u>2004/05</u> \$	<u>2005/06</u> \$	<u>2006/07</u> \$	<u>2007/08</u> \$
<u>Loan interest to individuals</u>							
	Mr B	Directors' emolument	400,910	611,334	892,003	1,357,734	1,739,635
	Mr C	Directors' emolument	184,471	239,900	347,437	437,239	571,885
	Mr D	Directors' emolument	<u>692,106</u>	<u>819,022</u>	<u>994,655</u>	<u>1,199,663</u>	<u>1,388,498</u>
Sub-total (a)			<u>1,277,487</u>	<u>1,670,256</u>	<u>2,234,095</u>	<u>3,030,636</u>	<u>3,700,018</u>
	Mr F	Sales commission	410,246	359,699	306,282	338,122	312,782
	Mr E	Sales commission	64,032	15,397	60,289	69,107	102,567
	Ms S	Sales commission	0	0	0	0	635,751
	Ms Z**	Sales commission	<u>0</u>	<u>8,236</u>	<u>0</u>	<u>0</u>	<u>0</u>
Sub-total (b)			<u>474,278</u>	<u>383,382</u>	<u>366,571</u>	<u>407,139</u>	<u>1,051,100</u>
Sub-total (c)	Ms Z**	Salaries and allowances	<u>0</u>	<u>0</u>	<u>6,663</u>	<u>0</u>	<u>5,614</u>
Total [(a)+(b)+(c)]			<u>1,751,765</u>	<u>2,053,638</u>	<u>2,607,329</u>	<u>3,437,775</u>	<u>4,756,732</u>
<u>Loan interest to corporations</u>							
	Company L	Sales commission	460,757	2,273,293	2,797,596	3,853,111	4,905,702
	Company P	Sales commission	892,171	1,001,712	1,068,620	1,207,238	1,368,823
	Company M	Sales commission	40,447	61,665	198,047	394,645	498,710
	Company N	Sales commission	<u>28,095</u>	<u>137,730</u>	<u>275,327</u>	<u>352,222</u>	<u>486,448</u>
Total			<u>1,421,470</u>	<u>3,474,400</u>	<u>4,339,590</u>	<u>5,807,216</u>	<u>7,259,683</u>
** Ms Z was an employee of [the Taxpayer]							
Items	Individual/ Corporation	Included in [the Taxpayer's] accounts as:	<u>2003/04</u> \$	<u>2004/05</u> \$	<u>2005/06</u> \$	<u>2006/07</u> \$	<u>2007/08</u> \$
<u>Bonus to directors and shareholders</u>							
	Mr B	Directors' emolument	600,000	700,000	708,525	300,000	508,525
	Mr C	Directors' emolument	600,000	700,000	708,525	300,000	508,525
	Mr D	Directors' emolument	<u>600,000</u>	<u>700,000</u>	<u>708,525</u>	<u>300,000</u>	<u>508,525</u>
Sub-total (d)			<u>1,800,000</u>	<u>2,100,000</u>	<u>2,125,575</u>	<u>900,000</u>	<u>1,525,575</u>
	Mr F	Salaries and allowances	600,000	700,000	708,525	300,000	508,525
	Mr E	Salaries and allowances	<u>600,000</u>	<u>700,000</u>	<u>708,525</u>	<u>300,000</u>	<u>508,525</u>
Sub-total (e)			<u>1,200,000</u>	<u>1,400,000</u>	<u>1,417,050</u>	<u>600,000</u>	<u>1,017,050</u>
			<u>474,278</u>	<u>383,382</u>	<u>366,571</u>	<u>407,139</u>	<u>1,051,100</u>
	Mr B	Entertainment expenses	8,525	8,525	0	8,525	0
	Mr C	Entertainment expenses	8,525	8,525	0	8,525	0
	Mr D	Entertainment expenses	8,525	8,525	0	8,525	0
	Mr F	Entertainment expenses	8,525	8,525	0	8,525	0
	Mr E	Entertainment expenses	<u>8,525</u>	<u>8,525</u>	<u>0</u>	<u>8,525</u>	<u>0</u>
Sub-total (f)			<u>42,625</u>	<u>42,625</u>	<u>0</u>	<u>42,625</u>	<u>0</u>
Total [(d)+(e)+(f)]			<u>3,042,625</u>	<u>3,542,625</u>	<u>3,542,625</u>	<u>1,542,625</u>	<u>2,542,625</u>
<u>Bonus to wives of directors and share-holders</u>							
	Ms S	Entertainment expenses (2003/04 to 2006/07) Salaries and allowances (2007/08)	8,525	8,525	8,525	8,525	8,525
	Ms V	Entertainment expenses (2003/04 to 2006/07) Salaries and allowances (2007/08)	8,525	8,525	8,525	8,525	8,525
	Ms W	Entertainment expenses (2003/04 to 2006/07) Salaries and allowances (2007/08)	8,525	8,525	8,525	8,525	8,525

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

Items	Individual/ Corporation	Included in [the Taxpayer's] accounts as:	<u>2003/04</u> \$	<u>2004/05</u> \$	<u>2005/06</u> \$	<u>2006/07</u> \$	<u>2007/08</u> \$
	Ms X	Entertainment expenses (2003/04 to 2006/07) Salaries and allowances (2007/08)	8,525	8,525	8,525	8,525	8,525
	Ms Y	Entertainment expenses (2003/04 to 2006/07) Salaries and allowances (2007/08)	8,525	8,525	8,525	8,525	8,525
Total			<u>42,625</u>	<u>42,625</u>	<u>42,625</u>	<u>42,625</u>	<u>42,625</u>

(19) By a letter dated 4 March 2010, the New Representative, on behalf of [the Taxpayer], objected to the above assessments in the following terms:

‘[The assessments] are excessive and rely upon incorrect inferences and broad unfounded assumptions made by you, ignoring the facts, about various expenses incurred by [the Taxpayer] in the various years and which are now being sought by you to be re-characterised, contrary to the decisions of [the Taxpayer], its Board of Directors and its auditors, as either commercially excessive or are simply fraudulent misrepresentations in the audited financial statements.’

(20) To support [the Taxpayer's] objections, the New Representative asserted the following:

- (a) ‘With respect, we are shocked you consider you have the evidence to support your claims and yet do not explicitly assert fraud or that somehow the transactions involving the various expenses denied deductibility under Section 16 do not fall foul of Sections 61 or 61A. It seems implicit you are charging the Directors and auditors and tax representatives with conspiring to defraud the Revenue by misrepresenting dividends and interest, both not [deductible] and known by all to be so for all these years, as salaries, “bonus” and commissions.’
- (b) ‘You continue to give weight to “working papers” over audited financial statements and representations made by [the Taxpayer] and personally by the Chairman of the Board of Directors, [Mr B].’
- (c) ‘You have no power to restate the audited financial statements ... Whatever may have been in the papers given [by] the auditors, clearly following scrutiny those were audited with the financial statements submitted with the returns becoming the final result and which same accounts were passed by the Board for submission to the shareholders at the AGM in accordance with the Companies Ordinance.’

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (d) ‘Contrary to your claim that “cash flow reports” showed that the amount charged through this account [account no. 2] is 1% of the amount due to each party; a calculation of the entries shows that the arithmetic is incorrect.’ (the New Representative’s calculation is at Appendix I of the Determination).
- (e) ‘The auditors have, quite rightly and in agreement with [the Taxpayer], disregarded the entries on which you rely and correct endorsed the transactions as sales commissions.’
- (f) ‘... were there interest in fact, there would be loan capital balances recorded in the balance sheets for the years under review, supported by loan agreements or Board minutes or some such, but there are none recorded, nor are there any supporting documents to indicate interest payable.’
- (g) ‘... there is ample paperwork to support the directors’ presentation of the accounts and a lack of any paperwork to support your contention for interest, apart from dated ledger entries (part only) and a superseded trial balance supplied to you by the auditors from their surviving working papers from some date in the past, but which is not consistent with the final accounts or ledgers.’
- (h) ‘It is not open to you to claim that no one did anything because there is no proof that they did anything and therefore the payments are not payments at all.’
- (i) ‘You claim that because “bonus can be kept unpaid for years” that is a ground for non-deductibility. This is a distortion of the law when you know very well that either an expense is committed to, and therefore s. 16(1) “incurred”, or it is not. When the expense is actually met by cash or other payment is irrelevant. You cannot rely on timing. The directors certainly have not nor the auditors. Your basis is a denial of your DIPN 13.’

(21) Having considered the available information and documents, the Assessor now considers that the Additional Profits Tax Assessments for the years of assessment 1999/00 to 2002/03 should be revised as follows:

Year of assessment	<u>1999/00</u>	<u>2000/01</u>	<u>2001/02</u>	<u>2002/03</u>
	\$	\$	\$	\$
Profit/ Loss per return [Fact (4)(a)]	(32,125)	398,957	906,659	1,206,931
<u>Add:</u> Loan interest to individuals	489,167 ⁽¹⁾			
Sums charged through the account no.2 ⁽²⁾ (per Appendix D)	-	267,896	401,631	1,444,018
Adjustment of balance per cash flow	-	-	-	1,209,347 ⁽³⁾

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

Year of assessment	<u>1999/00</u>	<u>2000/01</u>	<u>2001/02</u>	<u>2002/03</u>
	\$	\$	\$	\$
Directors' emolument overstated	-	-	-	300,000 ⁽⁴⁾
Bonus to directors and shareholders ⁽⁵⁾	-	1,042,625	2,042,625	4,042,625
Bonus to wives of directors and shareholders ⁽⁶⁾	-	<u>42,265</u>	<u>42,265</u>	<u>42,625</u>
Revised Assessable Profits	457,342	1,752,103	3,393,540	8,245,546
<u>Less:</u> Profits already assessed	-	<u>366,832</u>	<u>906,659</u>	<u>1,206,931</u>
Revised Additional Assessable Profits	<u>457,342</u>	<u>1,385,271</u>	<u>2,486,881</u>	<u>7,038,615</u>
Tax Payable thereon	<u>73,174</u>	<u>221,643</u>	<u>397,900</u>	<u>1,126,178</u>

Note

(1) General ledger is not available for the year of assessment 1999/00. According to the profit and loss statement as at 31 December 1999 and schedules provided by the Former Representatives (in their capacity as [the Taxpayer's] auditors) (Appendix J of the Determination), the loan interest to individuals was \$489,467 (\$492,135 - \$2,668 [paid to CAPT.BALI]). The breakdown of this sum is as follows:

Item	Individual	Included in [the Taxpayer's] audited accounts as:	\$
Loan interest to individuals			
	Mr B	Directors' emolument	248,381
	Mr C	Directors' emolument	36,662
	Mr D	Directors' emolument	<u>16,084</u>
Sub-total (a)			<u>301,127</u>
	Mr F	Sales commission	182,347
	Mr E	Sales commission	<u>5,993</u>
Sub-total (b)			<u>188,340</u>
Total [(a)+(b)]			<u>489,467</u>

(2) The breakdown of the item is as follows:

Items	Individual/ corporation credited	Included in [the Taxpayer's] audited accounts as:	<u>2000/01</u> \$	<u>2001/02</u> \$	<u>2002/03</u> \$
Sums charged through the account no. 2					
	Mr B	Directors' emolument	130,121	136,569	235,895
	Mr C	Directors' emolument	50,227	76,412	165,778
	Mr D	Directors' emolument	<u>10,342</u>	<u>44,644</u>	<u>498,408</u>
Sub-total (a)			<u>190,060</u>	<u>257,625</u>	<u>900,081</u>
	Mr F	Sales commission	66,423	95,112	368,767
	Mr E	Sales commission	<u>10,783</u>	<u>48,894</u>	<u>138,770</u>
Sub-total (b)			<u>77,206</u>	<u>144,006</u>	<u>503,537</u>
	Company P	Sales commission	0	0	38,634
	Company M	Sales commission	0	0	14
	Company N	Sales commission	<u>0</u>	<u>0</u>	<u>1,752</u>
Sub-total (c)			<u>0</u>	<u>0</u>	<u>40,400</u>
Total [(a)+(b)+(c)]			<u>267,896</u>	<u>401,631</u>	<u>1,444,018</u>

(3) Since [the Taxpayer] has failed to provide reasons for the adjustments [Facts (16)(e)], the Assessor considers that no deduction could be allowed for the corresponding sums included in 'Directors' emolument' and 'Salaries and allowances'. The total amount of the sums is thus added back to calculate [the Taxpayer's] assessable profits for the year of assessment 2002/03.

(4) See Facts (6)(d), and (16)(a).

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

(5) The breakdown of the item is as follows:

Items	Individual/ corporation	Included in [the Taxpayer's] audited accounts as:	<u>2000/01</u> \$	<u>2001/02</u> \$	<u>2002/03</u> \$
Bonus to directors and shareholders					
	Mr B	Directors' emolument	200,000	400,000	800,000
	Mr C	Directors' emolument	200,000	400,000	800,000
	Mr D	Directors' emolument	<u>200,000</u>	<u>400,000</u>	<u>800,000</u>
Sub-total (c)			<u>600,000</u>	<u>1,200,000</u>	<u>2,400,000</u>
	Mr F	Salaries and allowances	200,000	400,000	800,000
	Mr E	Salaries and allowances	<u>200,000</u>	<u>400,000</u>	<u>800,000</u>
Sub-total (d)			<u>400,000</u>	<u>800,000</u>	<u>1,600,000</u>
	Mr B	Entertainment expenses	8,525	8,525	8,525
	Mr C	Entertainment expenses	8,525	8,525	8,525
	Mr D	Entertainment expenses	8,525	8,525	8,525
	Mr F	Entertainment expenses	8,525	8,525	8,525
	Mr E	Entertainment expenses	<u>8,525</u>	<u>8,525</u>	<u>8,525</u>
Sub-total (e)			<u>42,625</u>	<u>42,625</u>	<u>42,625</u>
Total [(c)+(d)+(e)]			<u>1,042,625</u>	<u>2,042,625</u>	<u>4,042,625</u>

(6) The breakdown of the item is as follows:

Items	Individual/ corporation	Included in [the Taxpayer's] audited accounts as:	<u>2000/01</u> \$	<u>2001/02</u> \$	<u>2002/03</u> \$
Bonus to wives of directors and shareholders					
	Ms S	Entertainment expenses	8,525	8,525	8,525
	Ms V	Entertainment expenses	8,525	8,525	8,525
	Ms W	Entertainment expenses	8,525	8,525	8,525
	Ms X	Entertainment expenses	8,525	8,525	8,525
	Ms Y	Entertainment expenses	<u>8,525</u>	<u>8,525</u>	<u>8,525</u>
Total			<u>42,625</u>	<u>42,625</u>	<u>42,625</u>

(22) The Assessor now agrees that the sums charged through the account no. 2 for [Ms Z] (included in [the Taxpayer's] accounts as sales commission or salaries and allowances, see Fact (18)) could be allowed for deduction. Accordingly, he considers that the Additional Profits Tax Assessment for the year of assessment 2004/05 and the Profits Tax Assessments for the years of assessment 2005/06 and 2007/08 should be revised as follows:

Year of assessment	<u>2004/05</u> \$	<u>2005/06</u> \$	<u>2006/07</u> \$
Profit/ Loss per return [Fact (4)(a)]	5,107,345	(1,194,672)	3,787,555
<u>Add:</u> Sums charged through the account no.2	5,519,752 ⁽¹⁾	6,940,256 ⁽²⁾	12,010,801 ⁽³⁾
Bonus to directors and shareholders ⁽⁵⁾	3,542,625	3,542,625	2,542,625
Bonus to wives of directors and shareholders	<u>42,265</u>	<u>42,265</u>	<u>42,265</u>
Revised Assessable Profits	14,212,347	<u>9,330,834</u>	<u>18,383,606</u>
<u>Less:</u> Profits already assessed	<u>5,107,345</u>		
Revised Additional Assessable Profits	<u>9,105,002</u>		
Tax Payable thereon	<u>1,593,375</u>	<u>1,632,895</u>	<u>3,192,131</u>

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

Note

- (1) \$5,528,038 - \$8,286 [Appendix D of the Determination]
- (2) \$6,946,919 - \$6,663 [Appendix D of the Determination]
- (3) \$12,016,415 - \$5,614 [Appendix D of the Determination]

The Deputy Commissioner's Determination

4. The Deputy Commissioner decided by his Determination dated 23 March 2011 to:

- (a) Reduce Additional Profits Tax Assessment for the year of assessment 1999/00 dated 20 March 2006 showing additional assessable profits of \$1,500,000 with tax payable thereon of \$240,000 to additional assessable profits of \$457,342 with tax payable thereon of \$73,174.
- (b) Reduce Additional Profits Tax Assessment for the year of assessment 2000/01 dated 29 March 2007, showing additional assessable profits of \$4,000,000 with tax payable thereon of \$640,000 to additional assessable profits of \$1,385,271 with tax payable thereon of \$221,643.
- (c) Reduce Additional Profits Tax Assessment for the year of assessment 2001/02 dated 17 March 2008 showing additional assessable profits of \$4,000,000 with tax payable thereon of \$640,000 to additional assessable profits of \$2,486,881 with tax payable thereon of \$397,900.
- (d) Reduce Additional Profits Tax Assessment for the year of assessment 2002/03 dated 4 February 2009 showing additional assessable profits of \$15,000,000 with tax payable thereon of \$2,400,000 to additional assessable profits of \$7,038,615 with tax payable thereon of \$1,126,178.
- (e) Confirm Additional Profits Tax Assessment for the year of assessment 2003/04 dated 8 February 2010 showing additional assessable profits of \$6,258,485 with tax payable thereon of \$1,095,235.
- (f) Reduce Additional Profits Tax Assessment for the year of assessment 2004/05 dated 8 February 2010 showing additional assessable profits of \$9,113,288 with tax payable thereon of \$1,594,825 to additional assessable profits of \$9,105,002 with tax payable thereon of \$1,593,375.
- (g) Reduce Profits Tax Assessment for the year of assessment 2005/06 dated 8 February 2010 showing assessable profits of \$9,337,497 with tax payable thereon of \$1,634,061 to assessable profits of \$9,330,834 with tax payable thereon of \$1,632,895.

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (h) Confirm Profits Tax Assessment for the year of assessment 2006/07 dated 8 February 2010 showing assessable profits of \$9,704,610 with tax payable thereon of \$1,698,306.
- (i) Reduce Profits Tax Assessment for the year of assessment 2007/08 dated 8 February 2010 showing assessable profits of \$18,389,220 with tax payable thereon of \$3,193,113 (after deducting tax reduction) to assessable profits of \$18,383,606 with tax payable thereon of \$3,192,131 (after deducting tax reduction).

5. The Deputy Commissioner explained in his Determination dated 23 March 2011 that he had concluded that the expenses in dispute, which he summarized in paragraph 3(1) of his Determination as (a) the sums charged through the account no. 2 (which were then charged in the audited accounts as sales commission or directors' emolument); and (b) the bonus to [Mr B] and his family members, 'were not bona fide incurred by [the Taxpayer] in the production of its chargeable profits and that they could not be allowed for deduction' (paragraph 3(5)). He then indicated the matters he had taken into account in reaching this conclusion in respect of 'sales commission to the [Country H] Corporations', 'sales commission and bonus to [Mr B] and his four sons', 'sales commission to [Ms S], the wife of [Mr B]' and 'bonus to wives of directors and shareholders'. He also endorsed the Assessor's view of the Taxpayer's claim for deduction in respect of additional amounts of 'directors' emolument' and 'salaries and allowances' by reference to an accounting entry entitled 'adjustment of balance per cash flow' made to the related accounts corresponding to the year of assessment 2002/03, with the result that the claimed deduction should be disallowed and the total adjusted amount be added back to the computation of the assessable profits of the Taxpayer for the year of assessment 2002/03 (paragraph 3(6)). He further agreed with the Assessor's view that there was an overstatement in the directors' emolument charged for the year of assessment 2002/03 by \$300,000 and that amount should be added back to the computation of the assessable profits of the Taxpayer for the year of assessment of 2002/03 (paragraph 3(7)).

6. The Deputy Commissioner made the particular point in paragraph 3(8) of his Determination that the Taxpayer's 'audited accounts are by no means conclusive in determining the deductibility of an expense under Profits Tax. In order to qualify for deduction under section 16(1) of the Ordinance, an expense must have been incurred by the taxpayer for the purpose of earning chargeable profits. In deciding whether an expense is incurred by the taxpayer in the production of its chargeable profits, an objective test should be adopted and the whole circumstances have to be looked at'.

7. The Deputy Commissioner had considered whether, on the assumption that the sums paid under the account no. 2 were interest payments, those sums would qualify as a deductible interest expense under section 16 of the Inland Revenue Ordinance. He concluded that the condition in section 16(2)(c) was not satisfied in respect of those sums and accordingly, they were not deductible in computing the Taxpayer's assessable profits (paragraph 3(10) to (12)).

8. The Deputy Commissioner further invoked section 61A of the Inland Revenue Ordinance with respect to the charging of sales commission and bonus (or recorded as sales commission, directors' emolument, salaries and allowances or entertainment expenses) in the Taxpayer's accounts for the [Country H] Corporations, [Mr B] and his family members. He explained that having considered the specified seven matters provided in section 61A(1), he was able to conclude that Taxpayer together with the [Country H] Corporations, [Mr B] and his family members had entered into the charging transactions for the sole or dominant purpose of enabling the Taxpayer to obtain a tax benefit within the meaning of section 61A (paragraphs 3(13) to (15)). He considered that the revised assessments set out by the Assessor above were 'proper to counteract the tax benefit otherwise obtained by [the Taxpayer] from the relevant transactions' (paragraph 3(16)).

9. The Deputy Commissioner alternatively invoked section 61 of the Inland Revenue Ordinance on the basis that the relevant transactions were 'commercially unrealistic and hence artificial within the meaning of section 61', with the result that they 'should be disregarded and no deduction allowed in respect of the expenses allegedly incurred from such transactions' (paragraph 3(17), (18)).

The Taxpayer's Appeal

10. (a) Solicitors acting for the Taxpayer lodged with the Office of the Clerk to this Board on 20 April 2011 a notice of appeal against the Deputy Commissioner's Determination. Three grounds of appeal were raised, two of which criticized the Deputy Commissioner's two findings of fact concerning payments to family members and to the [Country H] Corporations respectively, and the third contended that the law on tax avoidance was incorrectly stated and wrongly applied.
- (b) At the end of the hearing of this appeal on 9 December 2011, the Taxpayer submitted through his counsel a draft amended notice of appeal seeking to add a ground of appeal against the Deputy Commissioner's finding concerning remuneration shown as 'bonus to directors and shareholders (included in [the Taxpayer's] audited accounts as directors emoluments or salaries and allowances and entertainment expenses)'. On the other hand, there was proposed an amendment deleting the elaboration of the ground of appeal concerning the application of the tax avoidance provisions.
- (c) The Taxpayer considered that the amendments 'do no more than make express the Appellant's challenge to the disallowance of "remuneration" items outside as well as within "account no. 2" as had been understood by the Respondent to be part of the Appeal'; that there was no bar to additional grounds of appeal being introduced; and that the Revenue 'would not be prejudiced by the additional ground'.

- (d) The Revenue submitted a written response to the Taxpayer's application to amend the grounds of appeal on 12 December 2011. The Revenue noted first that the additional ground was proposed after the close of the evidence and the Revenue's closing submissions. The Revenue objected to the inclusion of the additional ground, relying on the judgment of Bokhary PJ in China Map Ltd v Commissioner of Inland Revenue (2008) 11 HKCFAR 486 at paragraph 10. The Revenue also reminded this Board that it took issue at closing submissions with any attempt by the Taxpayer 'to drift outside the original scope of its grounds of appeal'. The Revenue further indicated that the Taxpayer had not taken notice or sufficient notice of the terms of section 66(3) of the Inland Revenue Ordinance and also had not provided an explanation of the lateness of the application for amendments of its grounds of appeal.
- (e) This Board shall rule on the Taxpayer's application for amendment of its grounds of appeal below when it sets out the issues for determination in this appeal.

The Evidence before this Board

11. The Taxpayer filed with this Board the signed witness statements of [Mr B], [Mr C], [Mr F] and [Mr D], all of whom asserted that they were unable to attend the hearing of this Board due to commitments at home or ill health. There was a signed statement of truth at the end of each of these witness statements. The Taxpayer submitted that the witness statements of [Mr B], [Mr C], [Mr F] and [Mr D] were admissible and should be considered by this Board. The Taxpayer also filed with this Board the witness statements of Mr AA, the General Manager of the Taxpayer and of Ms Z, the Project Administrator of the Taxpayer. Both Mr AA and Ms Z gave oral evidence before this Board.

12. (a) The Taxpayer has placed before this Board the following documents:
- The audited financial statements of the Taxpayer in the years ended 31 December 1999, 31 December 2000, 31 December 2001, 31 December 2002, 31 December 2003, 31 December 2004, 31 December 2005, 31 December 2006 and 31 December 2007;
 - Minutes of an EGM of the Taxpayer;
 - Correspondence between the Former Representatives/the Taxpayer and the Revenue between November 2003 and January 2010;
 - Correspondence between the New Representative and the Revenue from February 2009 to March 2011;

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

- Correspondence between the Revenue and the Taxpayer from June 2009 to March 2011;
 - Correspondence between Weir & Associates and the Revenue, the Clerk of the Board of Review and the Department of Justice.
- (b) The Revenue has placed before this Board the following documents:
- Certificate of incorporation of the Taxpayer;
 - Certificate of incorporation on Change of Name of the Taxpayer;
 - Profits Tax returns and Profits Tax computations for 1999/00 to 2007/08 years of assessment;
 - Extracts of the Taxpayer's audit working papers for all the relevant years of assessment;
 - Extracts of the Taxpayer's general ledger for the year 2006;
 - Correspondence between the Taxpayer's Former Representatives/ New Representative and the Revenue;
 - Notes of interview prepared by the Revenue dated 21 October 2008 and 1 April 2010 respectively;
 - Correspondence regarding the fixing of hearing dates.

13. Pursuant to the direction of this Board, the Revenue provided on 21 September 2011 particulars of the tax benefit, of the transactions which had the effect of conferring the tax benefit on the Taxpayer, and of persons having the relevant dominant purpose in relation to the Revenue's contention in this appeal that section 61A of the Inland Revenue Ordinance is applicable.

The Issues before this Board

14. (a) Mr Carolan for the Taxpayer outlined before this Board in his opening speech that the Taxpayer's case involved three issues: (i) the deductibility of the amounts summarized in Appendix D to the Deputy Commissioner's Determination and headed as 'charged through account number 2' under section 16 of the Inland Revenue Ordinance; (ii) the applicability of the tax avoidance provision in section 61A of the Inland Revenue Ordinance; and (iii) the applicability of the artificial transactions provision in section 61 of the Inland Revenue Ordinance. In

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

relation to (i), Mr Carolan also indicated that there was no dispute of the figures and that the Taxpayer's contention was that the amounts were deductible in whole.

- (b) Mr Carolan further indicated that in relation to ground 3 in the Notice of Appeal, he would not pursue paragraphs 3(b) and (c). He clarified that the Taxpayer's point in relation to ground 3 was the reliance by the Deputy Commissioner on section 61A of the Inland Revenue Ordinance as a matter of substance.
- (c) Mr Carolan furthermore indicated that Grounds 1 and 2 'encompass all the issues with regard to the deductibility of expenses and the application in this case of section 16'.
- (d) Mr Carolan in addition indicated that the Taxpayer would not pursue the deductibility of bonuses to the wives of the directors and shareholders (which have been described in the audited accounts as entertainment expenses). The Taxpayer accepts that these bonuses '[are] not deductible in the way that the other expenses were deductible because [they do] not represent any form of remuneration for work done for [the Taxpayer]'.

15. On the second day of the hearing, Mr Leung, counsel for the Revenue, produced a table containing 'Breakdowns of the expenses items "Directors' emolument, Salaries and allowances, Sales commission and Entertainment" charged in the Taxpayer's accounts' (together with an appendix combining these expense items throughout all the relevant years of assessment) to assist this Board in grappling with how the disputed items of expenses came about. Mr Carolan confirmed that the figures in this table and its appendix had been agreed by the parties and they corresponded to those that can be found in the Deputy Commissioner's Determination. This Board accordingly has annexed this table and its appendix at the end of this Board's Determination.

16. Mr Carolan sought leave to amend the grounds of appeal of Taxpayer on the second day of the hearing to add the following ground of appeal:

' [The] finding [that]:

the remuneration shown as "bonus to directors and shareholders, (included in the [Taxpayer's] audited accounts as directors emoluments or salaries and allowances and entertainment expenses", (for the shareholders) and appearing in the Determination at §(24) and (28) were not deductible expenses by reason of the matters stated in Reasons for Determination at §(5)(b),(i), (ii), (iii) and (v) [B133-34]

is in error by reason that:

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (a) There is no requirement for formal service contracts or agreements in this regard and there was evidence of the duties performed and basis on which the remuneration was determined. Further evidence is provided on such matters, (particularly in the witness statements of the 3 directors and shareholder, [Mr F] admitted on the appeal de novo before the Board).
- (b) There is evidence that the alleged services were rendered in the said witness statements and also in the statements of [Mr AA] and [Ms Z] who attended and testified at the appeal hearing.
- (c) There was explanation as to how the remuneration was arrived at and why there they were considered commensurate with the duties performed in the correspondence and notes of interview and this was developed further in the said four witness statements of the [Mr B family].
- (d) It matters not that the sums in dispute were credited without any definite terms of settlement. It is the incurring of the expense in the year of assessment that counts and not when it is paid: CIR v Lo & Lo [1984] HKC 220 @225 C-E, (item 4 of Appellant's list of authorities).
- (e) All 5 recipients of the remuneration were/are [Country H] citizens residing in [State Q] and had no liability to Hong Kong salaries tax and nor did the Company need to make any employer's return to HKIRD in respect of their employment/engagement which was performed, (save for regular but short term visits to Hong Kong) overseas so that the absence of formal employment records is unsurprising.'

17. The proposed ground of appeal discloses no arguable ground of appeal and this Board declines to give consent under section 66(3) of the Inland Revenue Ordinance.

18. On an appeal to the Board, the Board, not the Commissioner, is the fact finding body and the decision maker. The appeal is an appeal *from* a determination *against* an assessment.

19. As the Board said in D7/11, (2011-12) IRBRD, vol 26, 93, paragraph 3:

'The issue in an appeal before the Board is whether the assessment appealed against is incorrect or excessive, not whether the reasons given by the Commissioner were wrong. The appeal is a hearing de novo. The onus of proving that the assessment appealed against is excessive or incorrect is on the taxpayer.'

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

20. Hong Kong's appellate courts have held that the Board must consider the matter from the beginning, anew; and perform its 'ultimate function' to 'confirm, reduce, increase or annul the assessment' appealed against. In Shui On Credit Company Limited v Commissioner of Inland Revenue, (2009) 12 HKCFAR 392, Lord Walker of Gestingthorpe NPJ said in the Court of Final Appeal judgment at paragraphs 29 and 30 that the Board's duty is to perform an *original and administrative*, not an appellate and judicial, function of considering what the proper assessment should be:

' 29. *As the Board correctly observed, by reference to the decisions in Mok Tsze Fung v. CIR [1962] HKLR 258 and (after the amendment of s.64 of the IRO) CIR v. The Hong Kong Bottlers Ltd [1970] HKLR 581, the Commissioner's function, once objections had been made by the taxpayer, was to make a general review of the correctness of the assessment. In Mok Tsze Fung v Commissioner of Inland Revenue, Mills-Owens J said at pp 274-275: "His duty is to review and revise the assessment and this, in my view, requires him to perform an original and administrative, not an appellate and judicial, function of considering what the proper assessment should be. He acts de novo, putting himself in the place of the assessor, and forms, as it were, a second opinion in substitution for the opinion of the assessor' (emphasis added).*

' 30. *Similarly the Board's function, on hearing an appeal under s.68, is to consider the matter de novo: CIR v. Board of Review ex parte Herald International Limited [1964] HKLR 224, 237. The taxpayer's appeal is from a determination (s.64(4)) but it is against an assessment (s.68(3) and (4)) ...'*

21. Findings of fact are to be made by the Board which performs an *original and administrative* function of considering what the proper assessment should be. Subject to an appeal by way of case stated, the decision of the Board shall be final by reason of section 69 of the Inland Revenue Ordinance. Whether the Commissioner had erred in his 'findings' are irrelevant. The issue is whether an assessment is incorrect or excessive, not whether the findings in the determination are incorrect or excessive.

22. In Lee Yee Shing Jacky and another v Board of Review (Inland Revenue Ordinance) and another [2012] 2 HKLRD 981, Tang VP, as he then was, noted in paragraph 11 that:

' *The parties have proceeded on the basis that Article 10 [of the Hong Kong Bill of Rights] applies to the proceedings before the Board of Review, and that the Board of Review is an administrative tribunal.'*

but added in footnote 3 that:

' *Lam J pointed out at para 100 of his judgment and I respectfully agree:*

“[The Board of Review] exercises a function which is recognisably a judicial function, and does so in the public interest. It acts in accordance with detailed procedural rules which have close similarities to those followed in courts of law. Nevertheless it is not part of the judicial system of the state. Instead it is exercising (albeit with statutory sanction) [an administrative appeal function in aid of the duty of the Commissioner in tax assessment].”

23. Moreover, the Commissioner gave his reasons for his Determination as long ago as March 2011, about 6½ months before the hearing. No reason has been offered by the Taxpayer for not raising the proposed ground until after the close of evidence. The matters raised by the proposed ground are fact sensitive. For this Board to entertain such a ground after the close of the evidence would be unusual and plainly inappropriate if done without offering the party against whom the question is raised an opportunity to call further evidence, see China Map at paragraph 10. No explanation has been offered for the Taxpayer’s lack of due diligence in not raising the point earlier. Unexplained and, in the context of this case, inordinate delay is a further reason for this Board’s to decline the application.

Deductibility of Expenses

24. This Board has to determine whether the expenses, namely the amounts summarized in Appendix D to the Deputy Commissioner’s Determination and headed as ‘charged through account number 2’ and the bonuses to Mr B, Mr C, Mr F, Mr D and Mr E, are allowable deductions in the computation of the Taxpayer’s assessable profits. In the terms of section 16(1) of the Inland Revenue Ordinance, the question for determination is whether those expenses are ‘outgoings and expenses to the extent to which they are incurred during [the relevant years of assessment] by [the Taxpayer] in the production of profits in respect of which [the Taxpayer] is chargeable to tax’.

25. It is the Taxpayer’s burden, by reason of section 68(4) of the Inland Revenue Ordinance, to adduce evidence to prove that the expenses are within the ambit of section 16(1) of the Ordinance and hence deductible in the computation of the Taxpayer’s profits. This is part and parcel of the Taxpayer’s burden to prove that the assessments are excessive or incorrect.

26. It does not follow from the mere incurrence of an expense that the expense is deductible. A taxpayer has to identify and establish the nature and purpose of the expense. The expense has to be incurred ‘in the production of profits’.

27. The Taxpayer has filed 6 witness statements in support of its case. The Taxpayer, however, called only 2 of the makers of the witness statements to give evidence, namely Mr AA and Ms Z. The other four, namely Mr B, Mr C, Mr F and Mr D, did not come before this Board to give evidence.

Mr B, Mr C, Mr F and Mr D

28. Mr B, Mr C, Mr F and Mr D are 4 of the 5 recipients of the remuneration said to constitute the expenses the deductibility of which under section 16(1) of the Inland Revenue Ordinance is disputed before this Board.

29. Their witness statements dealt with factual issues which are central to the dispute between the Taxpayer and the Revenue. The interests of justice demand that the makers of these witness statements attend for cross-examination.

30. Mr B is the Chairman of the Taxpayer and a very important witness. Mr AA said in his evidence not only that: ‘Everything is dependent on the chairman’, but also that Mr B called the accounts staff of the Taxpayer directly from time to time to give instructions. Mr Carolan stated that Mr B was 81 years of age and not in good health. Mr B claims in his witness statement that he had been certified as physically incapacitated and so was unable to come to Hong Kong to attend the hearing of this Board. Yet there has been placed before this Board no medical evidence, whether to show that Mr B was unable to come to Hong Kong to give evidence at the hearing or at all. On the contrary, Mr B claims that he still attended his office every day. Against this background, this Board considers it unfair to the Revenue to attach any weight to the witness statement of Mr B. There is no credible or documentary evidence to substantiate the alleged inability of Mr B to attend to give oral evidence. There is no reason to deprive the Revenue of the opportunity to cross-examine Mr B.

31. In respect of Mr C, Mr F and Mr D, Mr Carolan stated that the sons were all busy as the dates of the hearing were in a very busy time of the year for them in State Q. The panel chairman pointed out that the hearing dates were agreed by the Taxpayer. Mr Carolan responded by saying that:

‘ I am not aware that any dates other than ones in December or November were ever offered. To my knowledge only dates in December or November were offered’.

32. On the fixing of dates for the hearing of this appeal, the following copy letters included in the Revenue’s hearing bundles show that:

<u>Date</u>	<u>From</u>	<u>To</u>	<u>Statement in letter</u>
10/06/11	Weir & Associates (‘WA’)	Clerk to Board of Review (‘Clerk’)	WA will be representing the Taxpayer and Mr Carolan is likely to be instructed
5/06/11	Department of Justice (“DOJ”)	Clerk	Grateful if hearing dates may be fixed in consultation with counsel’s diary
16/06/11	WA	Clerk	Ask that hearing dates be fixed in consultation with Counsel’s diary

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

<u>Date</u>	<u>From</u>	<u>To</u>	<u>Statement in letter</u>
17/06/11	Clerk	WA & DOJ	Parties are requested to consult each other and supply the Clerk with 3 sets of agreed available date for the hearing.
28/06/11	WA	DOJ	Our Counsel has confirmed that at present he is available on (1) 13 & 14/10/11, (2) 8 & 9/12/11, (3) 15 & 16/12/11.
29/06/11	WA	DOJ	Our Counsel has confirmed that he is available on (a) 3 & 4/10/11, (b) 8 & 9/12/11, (c) 15 & 16/12/11, (d) 19 & 20/12/11. We propose we put forward the dates (a), (b) and (c) to the Board of Review.
29/06/11	WA	Clerk	Our 3 sets of agreed available dates are (a) 3 & 4/10/11, (b) 8 & 9/12/11, (c) 15 & 16/12/11.
25/07/11	Clerk	WA & DOJ	Appeal is scheduled to be heard on 8 & 9/12/11.

33. Against this background, this Board sees no reason why this Board should attach any weight to the witness statements of Mr C, Mr F and Mr D. Significantly, they *chose* not to attend the hearing on hearing dates *agreed* to by both the Taxpayer with the Revenue. There is no reason why the Revenue should be denied the opportunity to cross-examine these 3 recipients. There is no reason to inflict prejudice on the Revenue.

34. In Kim Eng Securities (Hong Kong) Ltd v Commissioner of Inland Revenue (2007) 10 HKCFAR 213, Bokhary PJ referred in paragraph 5 to counsel for the taxpayer's citation of Wing Tai Development Co Ltd v Commissioner of Inland Revenue [1979] HKLR 642 on section 68(4) and his Lordship stated at paragraph 50 that a taxpayer is not entitled to benefit from sparsity in evidence as it bears the burden of showing that the assessments are wrong. The Taxpayer is not entitled to benefit by choosing not to call Mr B and 3 of his sons.

35. This Board therefore attaches no weight to the contents of the witness statements of Mr B, Mr C, Mr F and Mr D.

36. Where reference is made below to witness statements of these 4 persons, they are made for completeness (and in particular to show the contradictory nature of the Taxpayer's case) and without prejudice to this Board's decision to attach no weight to the contents of the witness statements.

Accounting Staff and Auditor

37. The Taxpayer has not called any of its accounting staff to give evidence.
38. The Taxpayer has not called its auditor or the auditor's staff in the material years of assessment to give evidence.
39. The Revenue took note of the absence of any one to explain the accounts and financial statements of the Taxpayer. Mr Leung submitted that '[the] failure to call these important and natural witnesses entitled the Board to draw inferences that their evidence, if given, would not have assisted the Appellant's case'. This Board accepts this submission. It is plainly correct to characterize evidence from accounting staff to be natural and of importance, bearing in mind, among others, the evidence from Mr AA that the cash flow reports in Appendix G to the Deputy Commissioner's Determination were prepared by accounts staff of the Taxpayer for the keeping of the accounts of the Taxpayer; the allegation, according to Mr B in his witness statement, that the "interest" as recorded on the Taxpayer's books in fact was not interest but was sales rebate; and Mr Carolan's submission that the Revenue 'may have been misled by some of the documentation they saw ... all such documentation was produced through the auditors'.
40. In Li Sau Keung v Maxcredit Engineering Ltd & Anor [2004] 1 HKC 434, CA, Le Pichon JA indicated in paragraph 28 that:

'But the plaintiff's evidence was unequivocal: he maintained that he had told So about the fall. Not only was it not put to the plaintiff that he never told So about it, So, who was an employee of the 2nd defendant, was not called to give evidence. Mr Chan SC rightly submitted that this was a matter that may properly be taken into account. In Cavendish Funding Ltd v Henry Spencer & Sons Ltd [1998] 6 EG 146 at 148-149, Aldous LJ cited the following passage from the judgment of Newton and Norris JJ in O'Donnell v Reichard [1975] VR 916 at 929:

"It is sufficient to say that in our opinion for the purposes of the present case the law may be stated to be that where a person without explanation fails to call as a witness a person who he might reasonably be expected to call, if that person's evidence would be favourable to him, then, although the jury may not treat as evidence what they may as a matter of speculation think that that person would have said if he had been called as a witness, nevertheless it is open to the jury to infer that that person's evidence would not have helped that party's case; if the jury draw that inference then they may properly take it into account against the party in question for two purposes, namely:

- (a) *in deciding whether to accept any particular evidence, which*

has in fact been given, either for or against that party, and which relates to a matter with respect to which the person not called as a witness could have spoken; ...”.

41. In Chinachem Investment Co Ltd v Commissioner of Inland Revenue (1987) 2 HKTC 261, Macdougall J (as he then was and hearing the appeal at first instance) stated at pages 273 and 282 that:

*‘ If a tax payer wishes to challenge the accuracy of its own audited statements and tax declarations made by a director it is **not sufficient merely to say that either a mistake was made or that the accounts were kept in a particular form which was incorrect “for convenience”**. Evidence to substantiate the mistake must be given in the strongest terms. In this case no such evidence was given.’ (emphasis supplied)*

On appeal to the Court of Appeal, Sir Alan Huggins VP indicated that:

- *‘It is accepted by the Commissioner that these accounts are not conclusive evidence of the matter in issue, and obviously that is rightly accepted. Nevertheless **the accounts must remain important and call for credible explanation**, because they are contemporaneous evidence of the Company’s intention. Yet no other member of its staff - not even the accountant - was called to explain how the “mistake” came to be made.’, at page 308 (emphasis supplied)*

- *‘The judge summed up the case as follows:*

“The Board, therefore, had before them a witness in Mrs. Wang whom they did not believe, no evidence in the form of company minutes or resolutions to support her evidence, accounts, which classified the properties as current assets, no claims for depreciation, no real explanation from Mrs. Wang as to the misclassification of the properties or the failure to claim depreciation, and finally, no evidence from any of the persons who could reasonably be expected to shed light on these matters. Bearing in mind that the burden lay on the taxpayer to establish that the Commissioner’s assessment was wrong, it is hardly surprising that the Board came to the decision to which they did. They were entitled to disbelieve Mrs. Wang and had ample reason to do so.”

I entirely agree and would dismiss this appeal.’ (at page 312)

Burden of proof

42. Bokhary PJ and Chan PJ pointed out in Real Estate Investments (NT) Ltd v Commissioner of Inland Revenue (2008) 11 HKCFAR 433 at paragraph 32 that it is possible although rare for an appeal to end and be disposed of on the basis onus of proof:

‘ It is natural and appropriate to strive to decide on something more satisfying than the onus of proof. And it should generally be possible to do so. But tax appeals do begin on the basis that, as s.68(4) of the Inland Revenue Ordinance provides, “[t]he onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant”. And it is possible although rare for such an appeal to end – and be disposed of – on that basis.’

43. In China Map, the Board noted that the taxpayers had put forward materially different versions of the facts on which they sought to rely and had led no evidence on a number of material matters. The Board held that ‘the [taxpayers] had not proved that the “stated intention” was in fact held, not to mention genuinely held, realistic or realizable’ and that ‘The [taxpayers] had not discharged the onus under section 68(4) of proving that any of the assessments appealed against was excessive or incorrect.’ The Court of Final Appeal held at paragraph 23 that:

‘ A distinction is to be drawn between finding the facts and determining whether a case is proved on the facts found. The Taxpayers’ essential assertion was that their intention was to acquire the properties concerned with a view to redevelopment by the erection of a building to be held as a long-term investment generating rental income. That was disputed by the Revenue, and thus put in issue. The Board made a finding on this issue, resolving it against the Taxpayers. It was upon this finding that the Board determined that the Taxpayers had failed to discharge their s.68(4) onus of proving that the assessments appealed against were excessive or incorrect.’

The Court of Final Appeal upheld the Board’s decision and dismissed the Taxpayers’ appeals.

44. The Taxpayer had the last word in the appeal. However, after Mr Leung had raised the matter of the absence of the evidence of accounting staff and the auditors before this Board, Mr Carolan’s response was that ‘[the] documents in this case, although they are sometimes difficult to follow and sometimes confusing, do speak for themselves’; that it was not necessary to have an auditor before this Board to give evidence because in the correspondence, the auditors had confirmed in detail the validity and propriety of their audit; and that the auditors ‘were unwilling to send a representative anyway’. On the other hand, he acknowledged that the Taxpayer’s own internal bookkeeping records were ‘perhaps confusing’.

45. The documents do not speak for themselves. It is no answer for the Taxpayer to say that the auditors were unwilling to send a representative. The Taxpayer could have applied, but has not, under section 68(6) of the Inland Revenue Ordinance to summon the auditor to give evidence.

Mr AA and Ms Z

46. The evidence of Mr AA and Ms Z, both in written and oral form, cannot assist this Board on the matter of the accounting treatment done to the expenses in question in the Taxpayer's appeal.

47. Mr AA, as stated above, was the General Manager of the Taxpayer. But he was not an accounting professional. He was not in a position to check or supervise effectively the account staff of the Taxpayer. Rather Mr B called the account staff of the Taxpayer from time to time to instruct them on matters. His testimony could not offer much to assist on the matter of accounting treatment of the expenses. Rather, his testimony, in the main, was on the business of the Taxpayer in Hong Kong in relation to the Country H Corporations and the daily operation of the Taxpayer through the interaction between him in Hong Kong and Mr B in Country H. He was shown for example the balance sheet of the Taxpayer in 2006 by Mr Leung, but while he acknowledged that he had seen this document, he said at first that he did not understand the meaning of 'director's loan account' on this document. Then he agreed with Mr Leung's suggestion that the amounts under 'director's loan account' were the loan account of all the directors and the companies. When he was questioned by the presiding chairman immediately thereafter as to whether the Taxpayer had loans, he replied that '[the Taxpayer] always get business from [the Country H Corporations], so [the Taxpayer] pay sales rebate or commission so [the Taxpayer] will pile up so [the Taxpayer] keep as a loan because [the Taxpayer] need financial things so [the Taxpayer] keep that'. He then denied suggestions that those amounts under 'director's loan account' were financing or working capital. He was unable to assist much on the handwriting that appears on the balance sheet. Nonetheless, he said that the Taxpayer 'do it because we need guaranteed funds ... so we get the money from them'. Although Mr AA insisted in his evidence that in respect of the balance sheet and the profit and loss statement of the Taxpayer in 2006, that the expressed terms therein of 'director's loan account' and 'director's loan interest' were 'actually speaking' of something else, he was unable to elaborate or explain further the assertion. This Board is not impressed with Mr AA's evidence, finds his evidence to be unreliable, and places no weight on it.

48. Ms Z, who handled project development at the material times, described the business of the Taxpayer in respect of the Country H Corporations. This involved the Taxpayer sourcing products from designers and factories for the Country H Corporations to promote and sell in Country H, mainly through cable television shopping channels. She exhibited 39 documents relating to 39 projects involving Mr B and his sons, and the respective Country H Corporations they were in charge of, in order to show the regular way of the Taxpayer doing business. However, she was not involved in the accounting side of

the running of the Taxpayer. Her evidence is of little assistance on the determination of the deductibility of the expenses in question.

Audited Accounts

49. The Taxpayer has referred to this Board its audited accounts in the relevant years of assessments extensively, as well as the responses its auditor gave to enquiries made by the Revenue to underline the validity of its case on appeal that the expenses in question were all deductible items for the assessment of profits tax. Mr Carolan has also referred this Board to the cases of Nice Cheer Investment v Commissioner of Inland Revenue [2011] 5 HKC 169, CFI and Re Ocean Time Development Ltd (HCCW 334/2004, 1 June 2006), CFI. Mr Carolan further submitted that if an item of expenditure is treated as deductible under ‘commercial accounting principles’, the treatment would constitute evidence of the deductibility of the item under the Inland Revenue Ordinance. Mr Carolan furthermore urged that the ‘strong evidence’ of the audited accounts in this regard ‘cannot be outweighed by the supposed effect of some internal draft account records of [the Taxpayer]’.

50. Mr Carolan has not correctly stated the roles of professional accountants and audited accounts. Tax appeals are decided by the Board, not by the professional accountants (however eminent), or audited accounts. Financial statements may not be appropriate for the assessment of tax.

51. The case of Nice Cheer Investment v Commissioner of Inland Revenue [2011] 5 HKC 169 cited by Mr Carolan went on appeal. In a judgment, FACV 23/2012, which was handed down on 12 November 2013 after the hearing of this case and reported in [2014] 2 HKC 112, Lord Millett NPJ said:

‘The role of the principles of commercial accounting

33. *The Commissioner submitted that the amount of any profits or losses during the year of assessment must be ascertained by reference to the ordinary principles of commercial accounting unless these are contrary to an express statutory provision in the Ordinance, and relied on the decision of this Court in Commissioner of Inland Revenue v Secan Ltd¹ for this purpose. That is a misreading of my judgment in that case. After citing the celebrated passage in the judgment of Sir John Pennycuik VC in Odeon Associated Theatres Limited v Jones², in which he explained the relationship between accountancy evidence and the ascertainment of the taxpayer’s assessable profits, I said³:*

“Both profits and losses therefore must be ascertained in accordance with the ordinary principles of commercial

¹ (2000) 3 HKCFAR 411.

² 48 TC 257 at page 273.

³ At page 419.

accounting as modified to conform with the Ordinance. Where the taxpayer's financial statements are correctly drawn in accordance with the ordinary principles of commercial accounting and in conformity with the Ordinance, no further modifications are required or permitted."

It should be noted that I said "in conformity with the Ordinance", not "in conformity with an express provision of the Ordinance".

34. *It is a fundamental principle of the constitution of Hong Kong, as of England, Australia, the United States and other democratic societies, that the subject is to be taxed by the legislature and not by the courts, and that it is the responsibility of the courts to determine the meaning of legislation. This is not a responsibility which can be delegated to accountants, however eminent. This does not mean that the generally accepted principles of commercial accounting are irrelevant, but their assistance is limited.*
35. *In the present case the subject matter of the tax is "profit", and the question what constitutes a taxable profit is a question of law. While the amount of that profit must be computed and ascertained in accordance with the ordinary principles of commercial accounting, these are always subject to the overriding requirement of conformity, not merely with the express words of the statute, but with the way in which they have been judicially interpreted. Even where the question is a question of computation, the court must "always have the last word"⁴.*
39. *It is clear beyond argument that accounts drawn up in accordance with the ordinary principles of commercial accounting must nevertheless be adjusted for tax purposes if they do not conform to the underlying principles of taxation enunciated by the courts even if these are not expressly stated in the statute⁵. In *Willingale v International Commercial Bank*⁶ Lord Fraser said that*

*"... where ordinary commercial principles run counter to **the principles of income tax** they must yield to the latter when computing profits or gains for tax purposes." (my emphasis)*

There are many other statements in the authorities to the same effect.'

⁴ Duple Motor Bodies Ltd v Inland Revenue Commissioners (note 15 supra in the CFA judgment) at page 753 per Lord Reid.

⁵ See B S C Footwear Ltd v Ridgway (note 16 supra in the CFA judgment) at page 562 per Lord Guest.

⁶ Note 17 in the CFA judgment.

‘ Financial statements

44. *It must be borne in mind that the new accountancy standards are directed to the preparation of financial statements and not tax computations, and that the two serve different purposes. Financial statements are prepared in order to give investors, potential investors, financial advisers, and the financial markets generally a true and fair view of the state of affairs of the company and in particular its financial position and profitability. Those who read them are concerned not with the past but with the future, and in particular the future profitability of the company. The Ordinance, however, is directed to the past. The Commissioner is not concerned with the likelihood that the taxpayer will make profits in future but whether it made them in the past.*
45. *The courts have had frequent occasion to comment that while a taxpayer’s financial accounts, drawn in accordance with ordinary principles of commercial accountancy, may be appropriate for the purpose of showing its financial position they may not be appropriate for the assessment of tax⁷.*

52. The earlier Court of Final Appeal case, Real Estate Investments (NT) Ltd v Commissioner of Inland Revenue (2008) 11 HKCFAR 433, was decided before the hearing of this appeal. In that case, Bokhary and Chan PJJ stated in paragraphs 33 to 35 that:

- ‘ 33. *As noted above, the Property had been described in the Taxpayer’s accounts from 1980 to 1995 as a fixed asset. It is argued on the Taxpayer’s behalf as follows. Such accounting treatment gave rise to a prima facie case that the profits in question arose from the sale of a capital asset. Consequently, the onus of proof shifted so that the Revenue had to show by evidence that the assessments were correct.*
34. *That argument is misconceived. Consistency between a taxpayer’s audited accounts and its stance does not go so far as to set up a prima facie case of that stance’s correctness in law. Where a taxpayer’s audited accounts are consistent with its stance, such consistency is some evidence in support of that stance. Even where accounting treatment amounts to strong evidence, it still falls to be considered together with the rest of the evidence adduced in the case.*
35. *As for the notion of a shifting onus, such a notion is seldom if ever helpful. Certainly it cannot shift the onus of proof from where s.68(4) of the Inland Revenue Ordinance places it, namely on a taxpayer who*

⁷ See the observations of Lord Warrington of Clyffe in The Naval Colliery case cited in para 14 of the CFA judgment.

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

appeals against an assessment to show that it is excessive or incorrect.
(emphasis supplied)

53. The question of deductibility of an expense for the purpose of section 16 of the Inland Revenue Ordinance is one that must be answered objectively. All circumstances must be looked at. The expense must have been *bona fide* incurred in the production of profits: So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416, CFI. Therefore, the Revenue and this Board are entitled to look not only into the audited accounts but also beyond into all circumstances. Mr Leung has in this connection suggested some of the possible surrounding circumstances, namely ‘the relationship between the payer and payee, the purpose or reason of the payment, and the basis and breakdown of the amount paid’. Mr Leung also submitted, relying on D94/99, IRBRD, vol 14, 603, that: ‘The lack of a rational basis for the payment may lead one to conclude that the amount is arbitrary, lacking in commercial reality and thus not *bona fide* incurred’.

Assertion: Expenses not related to interest

54. In the preceding paragraphs, this Board has examined the evidence placed before it by the Taxpayer in support of its appeal in on a relatively broad basis. In the paragraphs to follow, this Board will examine more specifically on assertions that the Taxpayer has relied on in support of its appeal on the question of the deductibility of the expenses in dispute.

55. Mr B, Mr C, Mr F and Mr D state in their witness statements that no part of the remuneration they received is in the nature of interest on the current account balance each of them holds with the Taxpayer. None of them attended the hearing to vouch on oath the truth of the assertions and be tested by cross-examination. This Board has already held that no weight would be attached to their witness statements. The Taxpayer’s own contemporaneous documents call for an explanation on how ‘interest’ came in. If it was not interest, how did it came about that ‘interest’ was recorded in the current account?

56. Moreover, the balance sheets of the audited financial statements showed the following amounts due by the Taxpayer to its shareholders.

<u>Year ending 31 December</u>	<u>Amount due to shareholders (\$)</u>
1999	3,242,289.98
2000	1,917,531.97
2001	5,781,484.02
2002	15,567,248.27
2003	16,482,844.92
2004	20,043,774.70
2005	25,631,330.58
2006	31,905,765.47
2007	38,021,377.08

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

57. Such amounts of money, it was said, was left in the current accounts to enable the Taxpayer to do business without third party or bank financing and incurring financial costs such as interest and because Mr B, Mr C, Mr F and Mr D could usually earn enough in Country H and they had no need for the money.

58. This Board does not accept these bare assertions. The contemporaneous documents and surrounding circumstances cry out for a credible explanation of how 'interest' appeared in the Taxpayer's books and in representations to the Revenue. None was forthcoming.

59. The accounts on the part of Mr B, Mr C, Mr F and Mr D do, in this Board's view, suggest that they provided working capital for the Taxpayer. The amounts provided by each was different. There is no explanation why each was said to provide different amounts of working capital without any return by way of interest.

60. There was in the documentation provided by the Taxpayer's former representative and auditors, Company R, a table on 'interest paid to directors for the year 2003' with manuscript notes on the percentage rate; and that the cash flow reports of the Taxpayer contained items concerning interest to one or more of Mr B, Mr C, Mr F and Mr D. The audit papers provided to the Revenue also lent support. Indeed account no. 2 was once named 'Directors' loan interest'. While Mr B states in his witness statement that he gave instructions some years ago to the bookkeeping staff of the Taxpayer a 'formula' to use for monthly accrual of all the expenses for related parties, which he said apparently had been understood as 'interest' on 'loans', there has been no elaboration and clarification of this statement before this Board in oral evidence that has been subject to cross-examination, be it from Mr B or from accounting or bookkeeping staff of the Taxpayer.

61. In the light of the above documentation, including the documentation provided by Company R on interest paid to directors for the year 2003, the lack of oral evidence to explain the reasons for the change in the nature or purpose of any alleged expenses, this Board finds that the Taxpayer shifted away from the interest claim to avoid being caught by section 16(2)(c) of the Inland Revenue Ordinance.

Assertion: Financial guarantee fee

62. Mr B describes the expenses in dispute in the Taxpayer's appeal in the following categories: (a) financial guarantee fees; (b) remuneration of directors and Mr F (which includes bonuses); (c) sales rebates to the Country H Corporations; (d) commissions to the Country H Corporations; (e) consulting fees to Mr E; and (f) some other minor expenses. This is to be contrasted with Fact (21) in paragraph 3 above.

63. As to financial guarantee fees, Mr B states that they refer to an arrangement that Company L guaranteed, in return for the financial guarantee fees the Taxpayer paid to Company L, the trading credit of Company M, Company N and Company P with the Taxpayer and invoiced these three corporations with a 5% mark up, which was a

contribution to Company L's costs and profits. Mr B then states that '[this] guarantee, has in part, consequently enabled [the Taxpayer] to function without the need to secure trade finance from banks and this provides additional security in doing business without pressure'. Mr B also states that he set the financial guarantee fees as a percentage after considering a number of factors.

64. However, when the documentary evidence before this Board is examined, there is nothing to support Mr B's claim that there was an arrangement of financial guarantee between the Taxpayer and Company L for the trading credit of Company M, Company N and Company P. There was also nothing in terms of calculation to show how the percentage representing the financial guarantee fees had been set by Mr B.

65. Rather, the audited accounts suggest instead that the Taxpayer was at the material times funded by its shareholders and not by Company L. In fact as at 31 December 2007, Company L owed the Taxpayer HK\$60.75 million, an increase from HK\$41.89 million in the previous year.

66. The financial guarantee claim is contradicted by an earlier claim that they were sales commission to Company L for its contribution, including soliciting the customers and following up the sales orders. That was what was stated by Company R, the auditors of the Taxpayer at the material times, on behalf of the Taxpayer in response to the enquiries of the Assessor. The purpose of payment is a question of fact. There was nothing before this Board to explain how this 'sales commission' representation came to be made on behalf of the Taxpayer by its auditors. There was nothing before this Board how the purpose of payment became 'financial guarantee fees'.

67. This Board rejects the Taxpayer's claim of financial guarantee fees.

Assertion: Sales Rebates/Commissions to Country H Corporations

68. Mr B describes in his witness statement that the Taxpayer's board of directors introduced a crude rebate system as an incentive for the Country H Corporations to place their business with the Taxpayer. The amounts were small early on and seldom exceeded 0.05%. The amounts were based on a number of factors but in all cases the sole purpose of the rebates was to retain the custom of the Country H Corporations. This was said at times to have involved negotiation and a little commercial 'give and take', with Mr B seeking to reach a 'consensus' decision through 'informal' meetings to 'ensure everyone is satisfied with the final numbers'. In respect of this decision, Mr B said that in arriving at the rebates to be paid, he sought 'to get to a "feeling" or "judgement" as to what is the minimum commercial reward [the Taxpayer] has to pay and can pay and which the corporation recipients would find satisfactory to ensure their continued commitment to [the Taxpayer]. This annual process is mostly judgement, honed over my years in business and as a father heading family businesses.'

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

69. Mr B also refers to sales commissions to the Country H Corporations, which as he has sought to explain, were paid by the Taxpayer to the Country H Corporations in respect of third parties introduced by the Country H Corporations. These sales commissions were recognized by the Revenue as deductible.

70. Mr B further indicates that there had been some confusion in the accounting of the Taxpayer and a change of bookkeeping staff, which had led to sales rebates and sales commissions having been combined under the heading of commissions. It was only in 2008 that the Taxpayer had corrected this matter. There is no evidence making good this bare assertion in the witness statement.

71. The sums now said by Mr B to be sales rebates were stated by Company R, the auditors of the Taxpayer at the material times, on behalf of the Taxpayer in response to the enquiries of the Assessor, to be sales commission to Company M, Company N and Company P for their contribution, including soliciting the customers and following up the sales orders. The purpose of the expense is a question of fact. There is no explanation for the change in the alleged purpose. Unexplained shifting of ground discredits the veracity of the allegation.

72. In any event, this Board is unable to accept that the sales rebates to the Country H Corporations were expenses incurred in the production of the profits of the Taxpayer. Mr B's account on how the sales rebates were determined, essentially by him, in respect of how much each of Company M, Company N and Company P, each owned by one of his sons, would get for retaining custom of the Taxpayer suggests more of a familial decision by a patriarch than a commercial decision by an experienced businessman. Additionally, the amounts recorded as sales rebate paid, say in 2006 as set out in Appendix C to the Deputy Commissioner's Determination, bear no correlation with the sales of the relevant Country H Corporation in the particular month. The amounts paid shown in Appendix C appear to be by and large constant from month to month. And if one further considers the range of total sales rebates paid to the Country H Corporations as a percentage of turnover of the Taxpayer, the fluctuation beginning with 0.078% in 2000, nil in 2001, 0.167% in 2002, 0.241% in 2003, 0.289% in 2004, 0.51% in 2005, 0.76% in 2006, 0.612% in 2007, 0.452% in 2008, 0.303% in 2009, to 0.298% in 2010 again bears no correlation with the change in sales/turnover (which can be conveniently noted in Fact (4)(b) in paragraph 3 above). The fluctuation in the percentages themselves also reveals no readily discernable pattern. It is difficult to comprehend how Mr B, the Taxpayer's board of directors, and the auditors all considered, as Mr B states in his witness statement, the sales rebates to be 'an acceptable cost for the return from having on-going business continuity' and presumably a satisfactory 'commercial outcome'. While they might all be satisfied that the sales rebates, as operated and being the outcome, made 'commercial sense' for them, the absence of Mr B or any of his sons who have worked closely with their father in the business of the Taxpayer and the Country H Corporations at the hearing of the Taxpayer's appeal means that neither this Board nor Mr Leung was able to seek elaboration or explanation from any one of them of how the sales rebates were agreed upon and did operate for the purpose described. While Mr B has sought to explain the amount of sales rebates to

Company M in 2008 in his witness statement, that example was one selected among many that this Board or the Revenue may wish to question him or any of his sons. A similar consideration applies to Mr C and Mr F, who have sought to describe and explain in their respective witness statements the rebates and commissions that Company M and Company P received in different years, with some of the commissions received actually recognized as deductible because they related to the introduction of third parties to the Taxpayer by these corporations.

73. This Board accordingly is not satisfied that the sales rebates to the Country H Corporations was an expense incurred in the production of the profits of the Taxpayer. This Board decides this factual matter against the Taxpayer.

Assertion: Remuneration of directors and shareholders (including bonuses)

74. The Revenue did not add back all items included as directors' emolument in the audited accounts of the Taxpayer in the relevant years of assessment. As indicated in Fact (21) in paragraph 3 above, the sums added back were those charged through account no 2, one amount of directors' emolument of HK\$300,000 in 2002/03 considered to be overstated, and bonus to directors and shareholders.

75. Mr B has outlined his role in the Taxpayer in his witness statement. He was in daily communication by telephone and fax with the staff of the Taxpayer in Hong Kong. He resents that the Revenue thinks that his work worth only HK\$100,000 per year. He indicates that as the Taxpayer and the related corporations 'are a family business we have not considered it necessary to spend resources on documenting our corporate contractual relations or other documents setting out the duties of each of the family members. ... We tend to be informal in all our internal corporate dealings and are always guided by professionals so we comply with any legal requirements for external purposes. I do not recall having ever been advised I must have contracts and the only documented board meetings are those to approve the annual financial statements ...'. He also states that '[a] lot of the work done by all the Directors and [Mr F] (and at times their deputies) is done in Country H to save costs for [the Taxpayer] which makes no separate contribution to the overheads of my maintaining Company L'.

76. Mr C, Mr D and Mr F have given in their respective witness statements their individual accounts on what they considered to be involvement in the Taxpayer's business.

77. There is no documentation before this Board which records the duties of Mr B's family members in the Taxpayer and the terms of remuneration (or compensation, being the North American equivalent expression) for discharging duties in respect of the Taxpayer's business. On the other hand, Company R, the auditors and first tax representatives of the Taxpayer, had asserted that the directors of the Taxpayer managed the Hong Kong office of the Taxpayer; that they carried out a number of services outside Hong Kong were 'sale managers' in Country H; and that there were no service contracts/agreements signed between the Taxpayer and its directors regarding terms of

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

employment and details of services. After a change of tax representatives, the Taxpayer provided to the Revenue through the new tax representatives representations that the Taxpayer was established as Mr B's buying office; that Mr C, Mr D and Mr F worked in the capacities of employees of the Taxpayer to develop products and of employees of the Country H Corporations to market, promote and deliver the products; and that the directors of the Taxpayer were not in fact rewarded by the Taxpayer as 'sales managers'. This is yet another shifting of grounds on the part of the Taxpayer.

78. There is also no documentation before this Board which records or set out how the remuneration now said to have been incurred for Mr B and his sons were calculated.

79. On the other hand, documentation that is before this Board, such as the organization chart of the Taxpayer, indicates that Mr C, Mr D, Mr F and Mr E held no position in the organization of the Taxpayer. It is true that Mr C and Mr D were at all material times directors and shareholders of the Taxpayer; and that Mr E was at all material times a shareholder of the Taxpayer. But that does not necessary mean that they had a part to play in the production of profits of the Taxpayer, the evidence before this Board as to their involvement in the business of the Taxpayer must be examined.

80. The Taxpayer, it can be safely described, was at the material years of assessment mainly a 'buying office' of the Country H Corporations. It served the Country H Corporations' need for suitable products to promote and sell in Country H. Thus the Taxpayer found factories to manufacture products at the request of and on the specifications of the Country H Corporations, oversaw the manufacturing (including quality control) and took care of the shipment of the products to Country H. The business of the Taxpayer, as described above, was carried out in Hong Kong by staff under the direction and supervision of Mr AA, the General Manager, who reported to Mr B on a daily basis, not by the directors.

81. The Country H Corporations, especially Company M, Company N and Company P, were the businesses of Mr C, Mr D and Mr F. The Country H Corporations were the customers of the Taxpayer. Mr C, Mr D and Mr F dealt with Ms Z of the Taxpayer in relation to the development of products specified by one of the Country H Corporations owned by one of them. Ms Z's liaison with Mr C, Mr D and Mr F, and more often than not, with 'deputies' of one of them in Country H, serves to illustrate the nature of the dealings being the Taxpayer serving the business needs of the Country H Corporations, with Mr C, Mr D and Mr F *working in furtherance of the business of the relevant one of Country H Corporations*.

82. This Board therefore rejects the Taxpayer's claim that the sums stated under Fact (21) in paragraph 3 above as the part of the directors' emolument credited to Mr C and Mr D were incurred in the production of profits. This Board also rejects the Taxpayer's claim that the part of salaries and allowances credited to Mr F under Fact (21) in paragraph 3 above were incurred in the production of profits.

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

83. Mr E is said by Mr B to have been a consultant to the board of directors of the Taxpayer. Mr B says that Mr E offered ‘general business advice’ and played ‘a mediatory role where necessary’. Mr E has not provided this Board with a witness statement as to what he did for the Taxpayer. The sums paid to Mr E and sought to be added back by the Revenue under Fact (21) in paragraph 3 above (which, strangely, came under sales commission and salaries and allowances in the Taxpayer’s audited accounts) are relatively less among the four brothers but curiously on a par with those paid to Mr D, who was not only a director and shareholder of the Taxpayer but also the owner of Company N, one of the Country H Corporations. There has been no explanation for making these payments to Mr E, save and except Mr B’s bare assertion that Mr E’s contributions ‘justify the expense’. This Board places no weight on this bare assertion.

84. This Board therefore rejects the Taxpayer’s claim that the sums stated under Fact (21) in paragraph 3 above as the sums paid to Mr E were incurred in the production of profits.

85. Fact (21) in paragraph 3 above also shows that the audited accounts of the Taxpayer recognized sales commissions paid to Mr F personally. Mr F has not sought in his witness statement to address these sums he was said to have received. When Mr B addresses sales commissions in his witness statement, his concern is sales commission paid to the Country H Corporations for introducing third party customers to the Taxpayer. There is plainly no basis for Mr F to receive sales commissions personally. This Board therefore rejects the Taxpayer claim that the sales commissions paid to Mr F under Fact (21) in paragraph 3 above were incurred in the production of profits.

86. Two types of bonuses were recognized in the audited accounts of the Taxpayer as having been paid to its directors and shareholders, namely an annual sum under directors’ emolument/salaries and allowances, which was adjusted annually by doubling the amount (‘Type A bonus’); and another annual sum under entertainment expenses, which remained fixed throughout at HK\$8,525 (‘Type B bonus’).

87. There is no documentation before this Board relating to how Type A bonuses came to be set and paid by the Taxpayer to its directors and shareholders. Mr B has not addressed in his witness statement the matter of Type A bonuses.

88. On the other hand, in 2009, Mr B attended an interview with the Revenue and later on by correspondence, the Taxpayer’s then representative confirmed that Mr B provided the following information during the interview (see Fact (13), paragraph 3 above):

- ‘(n) In relation to the remuneration paid to the Company’s directors, it included a fixed salary and a variable bonus based upon [Mr B’s] judgment, taking into account the contribution of each person, the complexity of their contributions, their standing and seniority.

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (o) None of the directors were remunerated for their services as directors. Since all the individuals spent less than 60 days in a year in Hong Kong, their remunerations were not chargeable to Salaries Tax.'

Later, the same representative asserted on behalf of the Taxpayer the following in response to the enquiries of the Revenue (see Fact (14), paragraph 3 above):

- ' (f) "... the Directors are not in fact rewarded by [the Taxpayer] as "sales managers". Their performance in many functions is rewarded by performance bonuses as well as nominal bonuses given at festive times of the year. ...".'

89. On the other hand, the account no. 3, from which the records of Type A bonuses were found, states that it is a record of bonus of fixed sums that were charged for Mr B and his four sons at festival times.

90. This Board notes that if one reads the two sets of communications together, they tend to indicate reasonably that the 'performance bonuses' referred to Type A bonuses and that the 'nominal bonuses' referred to Type B bonuses. However, the information from the account no. 3 would appear to contradict or at least discount substantially this reading. This Board therefore has to consider both possible understandings of the Type A bonuses.

91. This Board is not satisfied that the Taxpayer has established that Type A bonuses were expenses incurred in the production of profits of the Taxpayer. The same sums were paid to all directors and shareholders of the Taxpayer in each and every of the years in question. This contradicts the representations made on behalf of the Taxpayer that there was a performance based bonus set by Mr B on account of several factors, including the contribution of each person. Rather it appears to this Board that Type A bonuses tracked the trend of the sales or gross profit of the Taxpayer over the relevant years and resembled an annual distribution of funds to family members out of the funds of the Taxpayer.

92. If Type A bonuses were in fact bonuses paid in fixed sums at festive times as the information from account no. 3 suggests, then they are no different from Type B bonuses, which are considered next.

93. This Board is also not satisfied that the Taxpayer has established that Type B bonuses were expenses incurred in the production of profits of the Taxpayer. The same sums were paid to the wives of the directors and shareholders and categorized as 'Diwali bonus'. Mr Carolan has wisely withdrawn on behalf of the Taxpayer the objection against the Revenue disallowing the bonuses paid to the wives of the directors and shareholders. This Board finds no good reason to distinguish the nominal bonus paid on a festive occasion to the directors and shareholders and the bonus paid on the same occasion to their wives. They were both sums drawn out of the Taxpayer for a private family purpose.

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

94. This Board would apply the same reasons to reject the Taxpayer's claim that, on the proposition that Type A bonuses were bonuses paid in fixed sums at festive times (as the information from account no. 3 suggests), Type A bonuses were expenses incurred in the production of profits of the Taxpayer.

95. What remain are sums paid to Mr B but added back by the Revenue. The Revenue had added back sums paid to Mr B in the years of assessment which were recognized in the audited accounts as directors' emoluments. The Revenue did so on the basis that those sums paid to Mr B were interest expenses that failed to meet the conditions under section 16(2) of the Inland Revenue Ordinance for deductibility. For the reasons stated under the heading *Assertion: Expenses not related to interest*, this Board has held against the Taxpayer's contention that no part of the remuneration the Taxpayer's directors and shareholders received is in the nature of interest on the current account balance each of them holds with the Taxpayer.

96. There was also a sum of HK\$300,000 added back by the Revenue as directors' emolument overstated in the year of assessment 2002/03. A sum of that amount paid to Mr B as part of directors emolument in 2002/03 was at first stated by Company R as 'offshore consultancy fee'. The new tax representatives had not mentioned that Mr B acted as the Taxpayer's offshore consultant. The evidence of Mr AA, both written and oral, does not suggest that Mr B played the role of an offshore consultant for the Taxpayer. Mr B has not addressed this sum of HK\$300,000 in his witness statement. The Assessor considered that this sum of HK\$300,000 was an overstatement of directors' emolument paid to Mr B in 2002/03 after having regard to account no. 1 which records a monthly payment of HK\$25,000 to Mr B (i.e. an annual total sum of HK\$300,000). The Deputy Commissioner endorsed the Assessor's view. This Board considers that the Revenue was entitled to adopt this treatment to this sum of HK\$300,000.

Section 16

97. The Taxpayer has not explained how materially different versions of fact came to have been made.

98. This Board holds that:

- (a) none of the sums in dispute was incurred for the purpose alleged by the Taxpayer; and
- (b) none of the sums in dispute was incurred in the production of the Taxpayer's profits; and

accordingly rejects all the Taxpayer's claims for deductions of the expenses in dispute. The Taxpayer has not discharged its burden under section 68(4) of the Inland Revenue Ordinance of proving that the profits tax assessments under appeal were excessive or incorrect.

Section 61A

99. In Shui On Credit Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 392, Lord Walker of Gestingthorpe NPJ said that:

- ‘ 6. *Section 61A was enacted in 1986 as a general anti-avoidance measure. It can be applied so as to assess a person to tax only if (among other conditions) a transaction has been effected (s.61A(1)):*

“and that transaction has, or would have had but for this section, the effect of conferring a tax benefit on a person (in this section referred to as ‘the relevant person’).”

If the supposed tax benefit would not have been achieved even in the absence of s.61A (in colloquial terms, if for more mundane reasons the tax-avoidance scheme simply did not work) then logically s.61A cannot apply, as there is no tax benefit in the statutory sense. In a recent decision, Ngai Lik Electronics Co. Ltd v. CIR, 24 July 2009, FACV No. 29 of 2008, paras 93-97, this Court expressly left open the question whether that proposition is correct. The argument in the present case proceeded, in my view correctly, on the basis that it is correct. The question previously left open should now be taken to have been answered: a tax benefit in the statutory sense is required before s.61A is engaged, and so that section can apply only to a transaction which would otherwise avoid tax.’

100. This Board has decided that none of the expenses in dispute is deductible. There is no tax benefit and section 61A of the Ordinance does not apply.

Section 61

101. By similar reasoning, section 61 of the Ordinance which is applicable only in respect of a transaction ‘which reduces or would reduce the amount of tax payable ...’ does not apply.

Conclusion and disposition

102. For the reasons given above, this Board dismisses the Taxpayer’s appeal and confirms all the assessments appealed against as reduced or confirmed by the Deputy Commissioner.

Postscript

103. This Board regrets that the making of this Determination has taken considerably much more time than one may have desired. The fault is entirely that of the presiding chairman. This Board thanks the Taxpayer and the Revenue for their patience in awaiting this Determination.

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

Annexure

Breakdowns of the expenses items "Directors' emolument, Salaries and allowances, Sales commission and Entertainment" charged in the Taxpayer's accounts

<u>Year ended 31 Dec</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Directors' emolument *	601,127	1,090,690	1,757,625	4,818,750	3,377,487	4,070,256	4,659,670	4,230,636	5,525,593
Disallowed **	<u>301,127</u>	<u>790,690</u>	<u>1,457,625</u>	<u>4,518,750</u>	<u>3,077,487</u>	<u>3,770,256</u>	<u>4,359,670</u>	<u>3,930,636</u>	<u>5,225,593</u>
Allowed	300,000	300,000	300,000	300,000	300,000	300,000	300,000	300,000	300,000
Salaries & allowances *	1,492,394	1,857,180	2,464,019	3,491,472	3,101,638	3,526,838	3,430,472	2,547,826	3,216,683
Disallowed **	<u>0</u>	<u>400,000</u>	<u>800,000</u>	<u>1,890,678</u>	<u>1,200,000</u>	<u>1,400,000</u>	<u>1,417,050</u>	<u>600,000</u>	<u>1,017,050</u>
Allowed	1,492,394	1,457,180	1,664,019	1,600,794	1,901,638	2,126,838	2,013,422	1,947,826	2,199,633
Sales commission *	706,298	104,213	144,006	6,474,217	5,669,102	3,857,782	4,831,161	6,223,767	8,319,773
Disallowed **	<u>188,340</u>	<u>77,206</u>	<u>144,006</u>	<u>543,937</u>	<u>1,895,748</u>	<u>3,849,496</u>	<u>4,706,161</u>	<u>6,214,355</u>	<u>8,310,783</u>
Allowed	517,958	27,007	0	5,930,280	3,773,354	8,286	125,000	9,412	8,990
Entertainment *	141,797	200,742	263,099	386,362	301,185	279,274	246,586	162,016	96,381
Disallowed **	<u>0</u>	<u>85,250[^]</u>	<u>85,250[^]</u>	<u>85,250[^]</u>	<u>85,250[^]</u>	<u>85,250[^]</u>	<u>42,625[^]</u>	<u>85,250[^]</u>	<u>42,625[^]</u>
Allowed	141,797	115,492	177,849	301,112	215,935	194,024	203,961	76,766	53,756

* Figures per the Appellant's accounts (See Appendix A of the Determination)

** Computed in accordance with the figures mentioned in Statement of Agreed Facts.

[^] The Appellant's Counsel confirmed that the Appellant would not pursue the deduction claim of the bonus charged for the wives of Mr B and his four sons (\$8,525 x 5 persons x 8 years = \$341,000)

Note

Please see the Appendix of this breakdown for the total amounts of the above expenses charged by the Taxpayer, and the total sums disallowed and allowed by the Revenue for the years of assessment 1999/2000 to 2007/08.

(2014-15) VOLUME 29 INLAND REVENUE BOARD OF REVIEW DECISIONS

Appendix to the Breakdowns

<u>Expenses charged in accounts</u>	<u>Total charged</u>	<u>Disallowed</u>	<u>Allowed</u>
	\$	\$	\$
Directors' emolument	30,131,834	27,431,834	2,700,000
Salaries and allowances	25,128,522	8,724,778	16,403,744
Sales commission	36,330,319	25,930,032	10,400,287
Entertainment	2,077,442 [^]	596,750 [^]	1,480,692
Total	<u>93,668,117</u>	<u>62,683,394</u>	<u>30,984,723</u>

[^] Included a sum of \$341,000 being alleged as bonus paid to the wives of Mr B and his four sons. The Appellant's Counsel confirmed that the Appellant would not pursue the deduction claim of the sum.

Note

Tax benefit = Relevant standard rate x \$62,683,394