Case No. BR 3/72

Board of Review :

Chan Ying-hung, *Chairman*, A. K. W. Lui, A. E. Chaney & E. J. S. Tsu, *Members.*

12th February 1973.

Profits tax—assessment of chargeable profits—Inland Revenue Ordinance, s. 16(1)—initial and annual allowances in respect of capital expenditure—on provision of plant or machinery—Inland Revenue Ordinance, s. 37(1)—car purchased by company for use of Managing Director—question whether company entitled to full allowance in respect of the car as deduction from its chargeable profits.

The appellant company purchased a car for the use of its Managing Director. The company claimed running expenses and a depreciation allowance in respect of the car as a deduction from its chargeable profits. The assessor was not satisfied that the total use of the car was in the production of profits chargeable on the company; and he reduced the running expenses and depreciation allowance claimed in respect of the car by 1/7th, this amount being attributable, in his judgment, to the private use of the car by the Managing Director. The company appealed against the assessment of profits tax on the basis that it was irrelevant to the company's tax position whether the Managing Director had any private use of the car at weekends. On appeal.

Decision: Appeal allowed. Assessment reduced.

Mr. Johnson of Peat, Marwick, Mitchell & Co. for the appellant company.

B. M. Kelly for the Commissioner of Inland Revenue.

Cases referred to:—

1. Lowry v. Consolidated African Selection Trust Ltd., 23 T.C. 259.

2. British Insulated & Helsby Cables, Ltd. v. Atherton, (1925) All E.R. Rep. 623.

Reasons :

The Appellant company appeals against the determination of the Commissioner on an objection by the Company to the assessment of its profits for the year of assessment 1971-72. The facts stated in the Commissioner's determination have been agreed by the Company and are as follows : —

(1) The Company trades as General Merchants, Importers and Exporters. It is a private company and the directors hold controlling interests.

(2) During the year ended 31st December 1970 the Company purchased a Mercedes Benz 280S Sedan at a cost of $44,590.58. For this car, running expenses of $3,604.66 were charged in the accounts to 31st December 1970 and Depreciation Allowances totalling $17,836.00 claimed in the computation supporting the 1971-72 return.

(3) Mr. L. E. C., the Managing Director, has the use of the car and it is garaged at night at his residence in Hong Kong. No resolution on the provision and use of the car has been passed by the directors.

(4) The Assessor was not satisfied that the total use of the car was in the production of profits chargeable on the Company and in making the assessment for 1971-72 he reduced the running expenses and Depreciation Allowances by 1/7th. The Notice of Assessment was issued on 29th June 1971 and the Assessable Profit was calculated as follows :—

YEAR OF ASSESSMENT 1971-72

S. 18(2)—BASIS PERIOD : YEAR ENDED 31ST DECEMBER 1970

Profit after agreed adjustments ……..		$730,030.00
Plus Running expenses applicable to Director's private use, say 1/7th …….	$ 515.00	
Depreciation Allowances restricted for Director's private use, say 1/7th …….	$2,548.00	3,063.00
ASSESSABLE PROFIT ……		$733,093.00

The Company objected to the assessment on the ground that the sum of $3,063.00 for running expenses and depreciation should not be disallowed, as the motor car was provided by the Company for use by a Director and, that being the case, the Company contended that it was irrelevant to its tax position whether the Director had any private use of the car at weekends.

In his written determination, the Commissioner called attention to the provisions of section 16(1) of the Inland Revenue Ordinance (*Cap.* 112) the relevant parts of which are set out below : —

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

such person in the production of profits in respect of which he is chargeable to tax under this Part for any period, including—

(*a*) …

(*b*) …

(*c*) the allowances provided by Part VI (Depreciation etc.) to the extent to which the relevant assets are used in the production of such profits;".

He then proceeded to give his decision and the reasons therefor in the following terms : —

"(ii) The character of expenditure which will qualify as having been incurred in the production of profits has been considered by the Courts on numerous occasions and the tests to be applied can be conveniently summarised as—

(*a*) the expenditure must be more than merely connected with the trade or business;

(*b*) it must be directly related to the earning of the profits, or

(*c*) must, at the least, be seen to have been incurred in the course of earning the profits.

Further, in the case of depreciation allowances, the Hong Kong Ordinance requires that the relevant assets (in this case a motor car) are *used* in the production of the profits.

(iii) Applying these tests to the case of a director controlled company which provides a motor car to one of its directors partly for business use and partly for personal use, it is my view that the cost of the personal use borne by the company cannot be said to be an expense incurred in the course of earning the profits, nor can the personal use of the vehicle be said to be used in the production of the profits.

(iv) No precise details are available as to the extent of the personal usage by the Managing Director and the Assessor has disallowed one-seventh of the total running expenses and depreciation allowance on the basis of personal use at the rate of one day per week. In all the circumstances, I consider his estimate of personal usage to be most reasonable and accordingly confirm the quantum of the disallowance.".

According to the notice of appeal against the Commissioner's determination as filed by Messrs. Peat, Marwick, Mitchell & Co. the tax agents of the Company, the only ground relied on by the Company is that : —

"the amount of $3,063.00 being 1/7th of Motor vehicle expenses and Initial and Annual Allowances of Motor Car, has not been deducted in arriving at the amount of the profits charged to tax and was incurred wholly and exclusively in the production of the Company's profits.".

At the hearing of the appeal the following additional facts were agreed by the parties : —

(1) All profits of the Company are chargeable to Profits Tax.

(2) Mr. L. E.C., the Managing Director, and his wife reside with their son and daughter-in-law in Hong Kong. Mr. L.'s son is a director and full time

employee of the Company. Mr. L. and his family hold an 80% interest in the shares of the Company.

(3) The flat has two car parking spaces. One is occupied by his son's car and the other is used for the Company car. No rent is paid by the Company for this car space.

(4) The Company's office hours are 9 a.m. to 6 p.m. for 5 days a week plus a half day on Saturday. Mr. L. attends the office during normal working hours. He does not hold a driving licence and uses the Company car for transport between the residence and his office. There is occasionally other personal use of the car by Mr. L.

(5) The Company employs and pays for a full time driver who acts as Mr. L. E.C.'s chauffeur. This driver is employed during normal office hours, his monthly salary having risen from $550.00 per month in January 1970 to $680.00 per month by December 1970.

(6) From time to time Mr. L. is required to return to the office outside normal working hours to attend to urgent cables or other business. On these occasions he may be driven there by his son using his own car, may use a taxi or may use the Company car.

Mr. Johnson of Messrs. Peat, Marwick & Mitchell, who conducts the appeal on behalf of the Company, contends that as the Company agreed to provide a motor car for its Managing Director and to pay for its running expenses, the whole of such expenses and depreciation allowances in respect of this particular motor car shall be regarded as admissible deductions. The quantum of the running expenses and depreciation allowances is not in dispute in this case, but a principle is involved on which there does not appear to be any direct authority.

According to Mr. Johnson, the expenses of providing a motor car for the use of the Company's Managing Director represent outgoings wholly and necessarily incurred in the production of the Company's taxable profits. He emphasises the fact that the Revenue does not dispute that the remuneration of the Managing Director is a reasonable one. It consists of a monthly salary of $4,000.00 per month and management commissions of $69,250.65 for the whole year. Mr. Johnson, therefore, submits that even if the whole of the running expenses and depreciation allowances of $3,604.66 and $17,836.00 respectively were to be treated as part of the remuneration for the Managing Director's services, the sum total must still be regarded as reasonable having regard to the profits of the Company, which, for the year of assessment under review, came to $730,030.00 after agreed adjustments. In Mr. Johnson's submission, so long as these expenses—like expenses incurred for providing many common fringe benefits such as free or subsidised accommodation, medical treatment, etc.—are not outrageously unreasonable, they shall be allowed as deductible

expenses. He refers to **Lowry v. Consolidated African Selection Trust Ltd.**[1]. At p. 285, Lord Maugham says : "A man's salary with his consent can be paid in meal or malt as well as in money, and that salary is one of the items of expenditure which go to reduce the amount of profits and gains.".

It follows, so Mr. Johnson contends, that the facilities provided by the Company for the Managing Director are just as much a part of the cost of employing him as the payment of his salary and the precise nature of the use of the Company's car by the Managing Director is entirely irrelevant to the question whether such cost was incurred in the production of profits. In Mr. Johnson's own words : "We are not concerned with the use to which Mr. L. put the Company's car; we are concerned with the cost to the Company of Mr. L.'s services in his capacity as Managing Director". He also draws attention to the fact that although there was no written agreement or resolution regarding the arrangements whereby the Managing Director was given the use of the Company's car, the fact remains that all the invoices for fuel etc. for the vehicle were made out to and paid by the Company and such expenses were charged under the heading of "Travelling Expenses" in the accounts of the Company and it is his contention that in these circumstances the contract must be one which includes a term for the Managing Director being provided with a car.

Mr. Kelly, who appears on behalf of the Revenue, submits on the other hand, that the real issue is whether the expenses and allowances in question were wholly or exclusively incurred in the production of the Company's profits. He concedes that many assets used by a company are capable of private use as well as business use, and that in many cases, it may be reasonable to say that the expenses for providing an asset for the use of an employee as having been wholly or exclusively incurred in the production of profits. He cites as an example an air conditioner fitted in an employee's office. He disagrees with Mr. Johnson's proposition that private use is irrelevant in determining whether the expenses in this case were "incurred in the production of profits." According to him, if the nature and extent of the benefit are reasonable in relation to the services and position of an employee, such an expenditure is an allowable deduction, but in any such case, the Commissioner would expect some evidence that what on the face of it is a domestic expense is in fact a reward for service. Without some such evidence, the private use of the car cannot be dismissed as irrelevant, so Mr. Kelly argues.

On the evidence before us, we conclude—and so find—that the car in question was purchased for the purposes of the Company's business in general and the use of the Managing Director in particular. Having regard to the fact that the car is accepted on all sides as the "Company Car" and the entire cost of operating it has always been borne by the Company and treated as Travelling Expenses in the accounts of the Company and also the other facts hereinbefore stated, we find that it was clearly the intention of the Company and of its Directors that the Managing Director should be provided by the Company with the use of a car. We also find that although there was no formal agreement or resolution relating to the use of the car by the Managing Director, the service contract between him and the

[1] 23 T.C. 259 at p. 284.

Company in fact contemplates the use of a car by him at the Company's expense and that the running expenses and the depreciation allowances are fair and reasonable having regard to the size of the Company's profits.

As to the interpretation of the provisions of the Ordinance relevant to this case, it is to be noted in the first place that under section 16(1) of the Ordinance, outgoings and expenses to the extent to which they are incurred "in the production of profits" can be deducted from the income of a taxpayer. Secondly, as regards initial and annual allowances for depreciation in respect of machinery and plant, such allowances can only be made if the capital expenditure on the provision of the machinery or plant has been incurred "for the purposes of that trade, profession or business" (Section 37(1)) and then only to the extent that such machinery and plant "are used in the production of such profits." (Section 16(1)(*c*)). Taking these provisions together, it seems to us relatively clear that, for initial and annual depreciation allowances to qualify for deduction, the capital expenditure for providing the asset must have been incurred for the purposes of the taxpayer's business (Section 37(1)) and the asset must have been used in the production of the profits of such business (Section 16(1)(*c*)).

Both the Commissioner in his written determination and Mr. Kelly in his arguments before us stresses the use of the words "the extent" in section 16(1)(*c*) which, according to them, shows that it is only to the extent that the relevant assets are actually used in the production of profits that allowances for depreciation can be granted. We do not think either Mr. Johnson or any of us has any quarrel with the Revenue in this respect but, in our opinion, the requirement that the relevant assets must be "used in the production of the profits" is not the same as a requirement that such asset must itself be income-producing. In consequence, one may have an asset which can rightly be said to be used in producing the profits but not itself income-producing.

In our judgment, the fact that the car is occasionally used by the Managing Director for private purposes should not preclude the expenses which form the subject matter of this appeal from being incurred in the production of the Company's profits. This seems inevitable once we come to the conclusion that the provision of a car forms part of the remuneration for the Managing Director's services. We think that in determining whether or not it forms part of the Managing Director's remuneration, the use of a car and the reasonableness of its cost and operating expenses are some of the relevant facts to be taken into consideration. Having determined the inquiry in favour of the taxpayer, private use does not seem to us material in determining the further question whether the expenditure has been incurred in the production of the Company's profits.

In **British Insulated & Helsby Cables, Ltd. v. Atherton**[2]**,** Viscount Cave the Lord Chancellor, when dealing with a prohibition of deduction of 'any disbursements or expenses whatever, not being wholly and exclusively laid out or expended for the purposes of such trade or manufacture" says at p. 629 : —

[2] (1925) All E.R. Rep. 623.

> "It was made clear in the above cited case of Usher's Wilshire Brewery, Ltd. v. Bruce, and Smith v. Incorporated Council of Law Reporting for England and Wales, that a sum of money expended, not of necessity and with a view to a direct and immediate benefit to the trade, but voluntarily and on the grounds of commercial expediency, and in order indirectly to facilitate the carrying on of the business, may yet be expended wholly and exclusively for the purposes of the trade.".

By analogy, we think those passages apply with equal force to the inquiry as to whether the expenses in this appeal were wholly used in the production of profits.

For the reasons above stated, the appeal is allowed, and the assessment is reduced by deducting from the taxable profits the sum of $3,063.00.