

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D1/04

Profits tax – veracity of deductible expenses and non-trading receipts.

Panel: Kenneth Kwok Hing Wai SC (chairman), Michael Robert Daniel Bunting SC and Lawrence Lai Wai Chung.

Dates of hearing: 11 and 14 August 2003.

Date of decision: 7 April 2004.

The appellant claimed certain items were deductible expenses. They include: consultancy charges, management fee, sub-contracting charges and provision for doubtful debts.

The appellant also claimed some of the items in his bank deposits were non-trading receipts.

However, no contemporaneous documents of payment nor books or records were adduced to substantiate his claims.

Held:

In the absence of contemporaneous documentary evidence, the Board was not satisfied that the appellant did incur the items as claimed by him. Nor was the Board satisfied that the disputed items in his bank deposits, which were from known trading sources, were non-trading receipts.

Appeal dismissed and a cost of \$5,000 charged.

Chan Sin Yue for the Commissioner of Inland Revenue.
Taxpayer in person.

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Decision:

1. This is an appeal against the determination of the Acting Deputy Commissioner of Inland Revenue dated 18 March 2003 whereby:

- (a) Additional profits tax assessment for the year of assessment 1990/91 under charge number 2-5004665-91-1, dated 27 February 1997, showing additional assessable profits of \$170,000 with tax payable of \$25,500 was reduced to \$115,315 with tax payable of \$17,297.
- (b) Profits tax assessment for the year of assessment 1992/93 under charge number 2-4577772-93-7, dated 26 November 1993, showing assessable profits of \$50,000 with tax payable of \$7,500 was increased to \$2,128,477 with tax payable of \$319,271.
- (c) Profits tax assessment for the year of assessment 1993/94 under charge number 3-2932970-94-6, dated 30 March 2000, showing assessable profits of \$1,300,000 with tax payable of \$195,000 was reduced to \$1,293,419 with tax payable of \$194,012.
- (d) Profits tax assessment for the year of assessment 1994/95, dated 5 January 1996, showing assessable profits of \$378,699 was increased to \$678,479.

The items in dispute

2. The appellant is a certified public accountant and commenced his practice on 25 October 1989 in the name of Company A as the sole proprietor until 30 April 1996 after which a Mr B became a partner.

3. In his 1990/91 and 1992/93 profits tax returns and the 1993/94 and 1994/95 individual tax returns, the appellant reported the following assessable profits/losses:

Year	Basis period	Assessable profits/ (losses)
1990/91	Period to 31 December 1990	(\$86,259)
1992/93	Year ended 31 December 1992	(\$39,154)
1993/94	Year ended 31 December 1993	\$134,729
1994/95	Year ended 31 December 1994	\$378,699

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4. In the profit and loss accounts attached to the tax returns, the appellant recorded the following income and expenditures:

	1990/91	1992/93	1993/94	1994/95
	\$	\$	\$	\$
Turnover	<u>256,630</u>	<u>1,387,405</u>	<u>1,838,485</u>	<u>1,559,243</u>
Less:				
Consultancy charges	60,000	120,000	120,000	180,000
Management fee	-	840,000	-	-
Provision for doubtful debts	-	-	-	119,780
Sub-contracting charges	38,495	-	772,164	-
Rent & rates	84,000	-	138,000	152,000
Wages & salaries	101,028	320,168	537,628	593,798
Others	<u>59,366</u>	<u>146,391</u>	<u>135,964</u>	<u>134,966</u>
Total expenses	<u>342,889</u>	<u>1,426,559</u>	<u>1,703,756</u>	<u>1,180,544</u>
Net profit/(loss)	<u>(86,259)</u>	<u>(39,154)</u>	<u>134,729</u>	<u>378,699</u>

5. In March 1995, the assessor commenced an investigation into the tax affairs of the appellant.

6. By letter dated 24 September 1998, the assessor sent the appellant a bank deposit schedule from 1990/91 to 1994/95 and requested the appellant to explain the discrepancies between the bank deposits and reported turnover:

	1990/91	1992/93	1993/94	1994/95
	\$	\$	\$	\$
Discrepancy	133,079	1,207,631	266,526	-

7. By his determination, the Acting Deputy Commissioner:

(a) disallowed the items in bold print in paragraph 4 above, that is, the consultancy charges, management fee, provision for doubtful debts and sub-contracting charges; and

(b) added the discrepancies referred to in paragraph 6 above;

in computing the net assessable profits.

The grounds of appeal

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8. By letter dated 7 May 2003, the appellant gave notice of appeal on the following grounds (written exactly as it stands in the original):

- ‘ 1. The Determination prepared by the Acting Deputy Commissioner of Inland Revenue dated 18 March 2003 delivered on 14 April 2003 (‘ the Determination’) was wrong in fact in refusing to admit the Appellant’ s payment of consultancy charges of the following sums during each basis period for the year of assessment wholly for the production of assessable profits and hence wrong in law in refusing to allow the like amount in each basis period in paragraph 1(31) of the Determination.
 - (a) \$60,000 in 1990/91,
 - (b) \$120,000 in 1992/93,
 - (c) \$120,000 in 1993/94 and
 - (d) \$180,000 in 1994/95.
2. The Determination was wrong in fact in refusing to admit the Appellant’ s payment of management fee of the following sums during each basis period for the year of assessment wholly for the production of assessable profits and hence wrong in law in refusing to allow the like amount in each basis period in paragraph 1(31) of the Determination.
 - \$840,000 in 1992/93
3. The Determination was wrong in fact in refusing to admit the Appellant’ s payment of sub-contracting charges of the following sums during each basis period for the year of assessment wholly for the production of assessable profits and hence wrong in law in refusing to allow the like amount in each basis period in paragraph 1(31) of the Determination.
 - (a) \$38,495 in 1990/91 and
 - (b) \$772,164 in 1993/94
4. The Determination was wrong in fact in refusing to admit the Appellant’ s payment of doubtful debts provision of the following sums during each basis period for the year of assessment wholly for the production of assessable profits and hence wrong in law in refusing to allow the like amount in each basis period in paragraph 1(31) of the Determination.

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- \$119,780 in 1994/95

5. The Determination was wrong in fact that the 'Discrepancy shown in the bank deposits' were in fact non-trading receipts for the same year of assessment and hence wrong in law to include these items as taxable income the like amount in each basis period in paragraph 1(31) of the Determination.

(c) \$133,079 in 1990/91,

(d) \$1,207,631 in 1992/93 and

(e) \$266,526 in 1993/94

6. The Determination was wrong and ought to be set aside.

7. Alternatively, the Determination was made without careful consideration of the facts and dissection of operating expenses in the accounts, was made against the weight of evidence subsequently produced by the Appellant and was wrong and ought to be set aside.

...

Note: The Appellant has been supplying information and documents to the Respondent and the Appellant has after the Determination supplied to the Respondent those information/documents concerning expenses. The Respondent should take into account those information and documents for consideration if further allowance is given.'

Documents lodged by the parties

9. By letter dated 10 June 2003, the Clerk to the Board of Review notified the parties that the appeal would be heard on 11 August 2003 from 9:30 a.m. to 5:00 p.m. and requested the appellant to lodge written evidence and authorities by 28 July 2003 and the respondent to lodge written evidence and authorities by 4 August 2003.

10. On 28 July 2003, the appellant lodged his first bundle of documents:

Bundle marked

A1

Pagination

1 – 66

11. On 4 August 2003, the respondent lodged 3 bundles of documents:

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<u>Bundle marked</u>	<u>Pagination</u>
R1	1 – 324
R2	1 – 76
R3	1 – 71

12. On 6 August 2003, the appellant lodged his second bundle of documents:

<u>Bundle marked</u>	<u>Pagination</u>
A2	1 – 107

13. On 8 August 2003, the appellant lodged his third and fourth bundles of documents:

<u>Bundle marked</u>	<u>Pagination</u>
A3	1 – 32
A4	1 – 69

14. On 9 August 2003, the appellant lodged his fifth, sixth, seventh and eighth bundles of documents:

<u>Bundle marked</u>	<u>Pagination</u>
A5	1 – 10
	80001 – 80333
A6	70001 – 70182
	60001 – 60041
A7	1 – 55
	10001 – 10038
	30001 – 30169
A8	30170 – 30403
	40001 – 40069
A9	30600 – 30695
	20001 – 20150
	50001 – 50069

15. The appeal came up for hearing on 11 August 2003. It was part-heard and adjourned to 14 August 2003 at 9:30 a.m. when the hearing continued until its conclusion at about 6:30 p.m.

16. On 11 August 2003, the appellant lodged his tenth and eleventh bundles of documents:

<u>Bundle marked</u>	<u>Pagination</u>
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A10	1 – 26
A11	1 – 51

17. On 14 August 2003, the appellant lodged his twelfth bundle of documents:

<u>Bundle marked</u>	<u>Pagination</u>
A12	1 – 12

18. On 14 August 2003, the respondent lodged her fourth bundle of documents:

<u>Bundle marked</u>	<u>Pagination</u>
R4	1 – 9

The hearing

19. The appellant appeared in person.
20. The respondent was represented by Ms Chan Sin Yue.
21. The appellant gave evidence on oath. The appellant did not call any other witness.
22. Ms Chan Sin Yue did not call any witness.

Our decision

The law

23. Section 68(4) of the Inland Revenue Ordinance, Chapter 112 ('IRO'), provides that the onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.

24. Section 16(1) provides that:

'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 ...

- (d) bad debts incurred in any trade, business or profession, proved to the satisfaction of the assessor to have become bad during the basis period*

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for the year of assessment, and doubtful debts to the extent that they are respectively estimated to the satisfaction of the assessor to have become bad during the said basis period notwithstanding that such bad or doubtful debts were due and payable prior to the commencement of the said basis period:

Provided that:-

(i) deductions under this paragraph shall be limited to debts which were included as a trading receipt in ascertaining the profits, in respect of which the person claiming the deduction is chargeable to tax under this Part, of the period within which they arose, and debts in respect of money lent, in the ordinary course of the business of the lending of money within Hong Kong, by a person who carries on that business;'

25. To establish that expenses are deductible, the appellant must show that:
- (a) the expenses were incurred by him;
 - (b) the expenses were incurred during the basis period for that year of assessment; and
 - (c) the expenses were incurred in the production of profits.
26. To establish that debts are deductible, the appellant must show that:
- (a) the debts were incurred in any trade, business or profession;
 - (b) the debts were included as a trading receipt in ascertaining the profits in respect of which the appellant was chargeable to tax of the period within which they arose; and
 - (c) the debts had become bad during the basis period for the year of assessment or doubtful to the extent that they were estimated to have become bad during the basis period.

Consultancy charges

27. We turn now to consider each of the disputed items.

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28. The appellant claimed deduction of consultancy charges in the sums of \$60,000 (1990/91), \$120,000 (1992/93), \$120,000 (1993/94) and \$180,000 (1994/95).

29. The first question is whether the appellant in fact incurred any consultancy charges.

30. A follow-up question is whether the appellant has paid any consultancy charges, and if so, when and how, and if not, why not.

31. The case put forward by the appellant in ground 1 of his grounds of appeal is that he had paid the consultancy charges. He asserted at the hearing that the payments were made by cheques. He placed some 1,800 pages of documents before us but none of the alleged payment cheques was among them.

32. Ms Chan Sin Yue made the point that despite the Revenue's repeated requests, the appellant had not submitted any contemporaneous books or records to substantiate any of his claims. The appellant asserted in his reply that the books and accounts had been sent to the Revenue. When asked what books had been sent to the Revenue, he referred us to pages 58 to 76 of the B1 bundle as the only books sent to the Revenue. None of these copy documents entitled 'Transactions by Account' at pages 58 to 71 of the B1 bundle has anything to do with any of the items in dispute.

33. In the absence of any contemporaneous documents of or evidencing payment and in the absence of any contemporaneous books or records, we are not satisfied on a balance of probabilities that the appellant did in fact incur any consultancy charges. The appeal on this item fails.

Management fee

34. The appellant claimed deduction of management fee in the sum of \$840,000 (1992/93).

35. The case put forward by the appellant in ground 2 of his grounds of appeal is that he had paid the management fee. He asserted at the hearing that the payments were made by cheques but did not produce any of the alleged payment cheques.

36. The appellant had not submitted any contemporaneous books or records to substantiate his management fee claim.

37. On 25 July 2003, the appellant supplied copies of what purported to be debit notes issued by Company C to Company A charging rental for office for the period from January to December 1992 in the total sum of \$134,000 (R1 pages 289 to 292). However, the appellant offered no explanation why rental came to be payable to Company C in the calendar year of 1992,

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why he charged management fee in his profits and loss account for 1992/93 when part of the fee was said to be rental, and why the whole item was categorised as management fee in his grounds of appeal.

38. In the absence of any contemporaneous documents of or evidencing payment and in the absence of any contemporaneous books or records, we are not satisfied on a balance of probabilities that the appellant did in fact incur any management fee or other expense under the 'management fee' item. The appeal on this item fails.

Sub-contracting charges

39. The appellant claimed deduction of sub-contracting charges in the sums of \$38,495 (1990/91) and \$772,164 (1993/94).

40. The case put forward by the appellant in ground 3 of his grounds of appeal is that he had paid the sub-contracting charges. He asserted at the hearing that the payments were made by cheques but did not produce any of the alleged payment cheques.

41. The appellant had not submitted any contemporaneous books or records to substantiate his sub-contracting charges claim.

42. The appellant asserted for the first time in his witness statement (A1 page 3) that the 'sub-contracting charges' were in fact other charges and not sub-contracting charges. However, he offered no explanation why he charged sub-contracting charges in his profit and loss accounts when he had in fact not incurred any sub-contracting charges and why the charges were still categorised as sub-contracting charges in his grounds of appeal.

43. In the absence of any contemporaneous documents of or evidencing payment and in the absence of any contemporaneous books or records, we are not satisfied on a balance of probabilities that the appellant did in fact incur any charges under the sub-contracting charges item. The appeal on this item fails.

Consultancy charges, management fee, and sub-contracting charges

44. The consultancy charges, management fee and sub-contracting charges were all said to have been paid to Company C.

45. The appellant's case was that one Ms D and one Mr E (a brother of the appellant) were the only persons at Company C who provided the services.

46. The following table compares these expenses with the reported turnover of the appellant:

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	1990/91	1992/93	1993/94	1994/95
	\$	\$	\$	\$
Turnover	<u>256,630</u>	<u>1,387,405</u>	<u>1,838,485</u>	<u>1,559,243</u>
Consultancy charges	60,000	120,000	120,000	180,000
Management fee	-	840,000	-	-
Sub-contracting charges	38,495	-	772,164	-
Total of three expenses	<u>98,495</u>	<u>960,000</u>	<u>892,164</u>	<u>180,000</u>
Expenses/turnover	<u>38.38%</u>	<u>69.19%</u>	<u>48.53%</u>	<u>11.54%</u>

47. In these four years of assessment, the appellant charged wages & salaries in the sums of \$101,028 (1990/91), \$320,168 (1992/93), \$537,628 (1993/94) and \$593,798 (1994/95). We do not believe the appellant incurred expenses of such magnitude and proportion, bearing in mind that only two persons at Company C were said to have provided the services.

48. Even if, contrary to our findings above, the appellant did in fact incur any consultancy charges, management fee or sub-contracting fee, we are not satisfied on a balance of probabilities that any charge or fee which might in fact have been incurred was incurred in the production of profits.

Provision for doubtful debts

49. The amount of provision asserted in ground 4 of the appellant's grounds of appeal was \$119,780 for 1994/95. By letter dated 21 July 2003 to the Revenue, the appellant reduced the amount to \$58,950 (A1 page 29).

50. The appellant made no attempt to satisfy us that \$119,780 or \$58,950 or any part of either sum was included in the reported turnover or trading receipt in respect of the 1994/95 year of assessment or any other year of assessment.

51. The appellant did not demonstrate that he had taken any step to recover any of the debts. Ms Chan Sin Yue took us through the voluminous documents supplied by the appellant to demonstrate the conflicts and inconsistencies in the appellant's assertions and documents.

52. The appeal on this item fails.

Discrepancy

53. We turn now to the bank deposit schedule sent by the assessor to the appellant under cover of the letter dated 24 September 1998. The assessor added up the amounts of deposits into the appellant's current account with Bank F and the appellant's current account with Bank G for

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1990/91, 1991/92, 1992/93, 1993/94 and 1994/95, and deducted the amounts of returned cheques and money deposited from known non-trading sources (which were listed in an appendix) to arrive at a deemed business turnover which was then compared with the reported turnover. The difference is the discrepancy. In this appeal, we are only concerned with the discrepancies of \$133,079 in 1990/91, \$1,207,631 in 1992/93 and \$266,526 in 1993/94. These add up to \$1,607,236.

54. Examination of books and records is a direct method to verify the correctness of the reported business turnover. In cases such as this where the appellant did not furnish the Revenue with any of his books or records despite repeated requests, the Revenue had to resort to other methods. Examination of the deposits into the bank accounts of the appellant's practice was one such method.

55. The discrepancy schedule was sent to the appellant on about 24 September 1998.

56. In the appellant's response dated 16 April 1999, he took issue on 11 items totalling \$56,940 (B1 pages 85 to 86).

57. By letter dated 31 May 1999 the assessor asked for further information in relation to the then disputed items (B1 page 87).

58. By fax dated 16 April 1999 which was not transmitted until 6 July 2000 (B1 pages 88 to 96), the appellant claimed that sums totalling \$1,748,024.5 in relation to the Bank F account in the calendar year 1992 were not trading receipts. The appellant did not give any reasons or particulars.

59. On various dates in June 2003 [that is, 6 June 2003 (A7 pages 30001 to 30169 and A8 pages 30170 to 30403), 9 June 2003 (A8 pages 40001 to 40069), 13 June 2003 (A9 pages 20001 to 20150), 18 June 2003 (A9 pages 50001 to 50069), 20 June 2003 (A9 pages 30600 to 30695) and 23 June 2003 (A7 pages 10001 to 10038)], the appellant sent some 825 pages of documents to the Revenue, without stating explicitly the relevance of those documents.

60. The appellant gave evidence on why he said the items in the bank deposit schedule which he disputed were not trading receipts. His main contention was that those were receipts on behalf of a business in the name of 'Company A' which was operated by Company C. He said that 'Company A' was different from his own practice which was 'Company A certified public accountant'.

61. Having considered all relevant matters, we reject his evidence, both on this and all the other disputed items.

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62. Company C did not charge any salary or wages in its accounts. It was simply not possible for Ms D and Mr E to have provided services to earn for 'Company A' the alleged fee-income, **in addition to** providing the appellant with the services under the other disputed items.

63. Even if Company C had provided any service to its clients, there was no reason why Company C did not:

- (a) invoice its clients in its own name;
- (b) insert a request in its debit notes that cheques should be made out in favour of 'Company C' (instead of 'Company A' in the purported debit notes produced by the appellant); or
- (c) open a bank account with a bank in the name of the business as operated by it.

64. Last but not least, there is no contemporaneous documents of any payment or account by the appellant to Company C of the amounts said to have been received by the former on behalf of the latter.

Conclusion

65. For the reasons given above, the appellant fails on all the disputed items and his appeal wholly fails.

Disposition

66. We dismiss the appeal and confirm all the assessments appealed against as reduced or increased (as the case may be) by the Acting Deputy Commissioner.

Costs

67. We are of the opinion that this is a wholly unmeritorious appeal. Pursuant to section 68(9) of the IRO, we order the appellant to pay the sum of \$5,000 as costs of the Board, which \$5,000 shall be added to the tax charged and recovered therewith.

Postscript

68. We thank Ms Chan Sin Yue for her helpful and thorough submission.