Case No. D107/00

Profits tax – additional tax – deductibility – fees paid to a consultancy company by a barrister – sections 61, 68(4) and 68(9) of the Inland Revenue Ordinance (' IRO').

Panel: Kenneth Kwok Hing Wai SC (chairman), Berry Hsu Fong Chung and Mitzi Leung Leung Mee Chee.

Date of hearing: 11 November 2000.
Date of decision: 12 December 2000.

The taxpayer appealed against the determination of the Commissioner of Inland Revenue to increase his additional tax by claiming that consultancy fee paid by him should be allowed in full in computing his assessable profits.

The taxpayer in his profit and loss account of the Practice for the year ended 31 March 1995 included an expense item as ' Consultancy Fee paid to ServiceCo2' in the sum of $600,000. The said sum consists of (a) provision of administration support in the sum of $13,000 per month; (b) provision of chauffeur in the sum of $12,000 per month; (c) provision of car in the sum of $15,000 per month and (d) provision of study room in the sum of $10,000 per month.

Held:

1. The taxpayer has not proved that:

   (a) he had in fact incurred the Fee;

   (b) if contrary to the Board' s finding, he had incurred the Fee, the Fee was incurred in the production of profits in respect of which he was chargeable to tax.

2. It was commercially unrealistic for the taxpayer to incur the fee at $50,000 per month, $27,000 of which was on chauffeur and car, in view of the fact that he had already incurred $91,250 on local travelling expenses. It was also commercially unrealistic for the taxpayer to incur $13,000 per month on administration support said to be provided by his wife and $10,000 per month on a ' study room' or ' second office' in view of the fact that he had already incurred on average $18,415

a month to ServiceCo1 which included rental for his chambers and all the staff in chambers.

3. The Fee is artificial within the meaning of section 61 of the IRO and is to be disregarded.

4. The taxpayer has not discharged the onus under section 68(4) of proving that the assessment appealed against is excessive or incorrect.

5. The Board considered that the appeal is frivolous and vexations and an abuse of the process. Pursuant to section 68(9) of the IRO, it orders the taxpayer to pay the sum of $5,000 as costs of the Board, which shall be added to the tax charged and recovered therewith.

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

Cases referred to:

Seramco Trustees v Income Tax Commissioner [1977] AC 287
D44/92, IRBRD, vol 7, 324

Cheung Mei Fan for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. This is an appeal against the determination of the Commissioner of Inland Revenue dated 30 June 200 increasing the additional profits tax assessment for the year of assessment 1994/95 under charge number 3-2236021-95-4, dated 5 March 1997, showing additional assessable profits of $264,715 with additional tax payable thereon of $39,707 to additional assessable profits of $600,000 with additional tax payable thereon of $90,000.

The agreed facts

2. Based on the statement of facts in the determination agreed by the Taxpayer, we make the following findings of fact.

3. The Taxpayer objected to the additional profits tax assessment for the year of assessment 1994/95 raised on him, claiming that consultancy fee paid by him should be allowed in full in computing his assessable profits.

4. The Taxpayer commenced his practice (' the Practice') as a barrister in Hong Kong in 1987.

5. The Taxpayer and his wife were the directors and shareholders, each holding 50%, of a private company (' ServiceCo2') incorporated in Hong Kong on 1 May 1990, having an authorised and paid-up capital of $10,000 at all material times.

6. Details of the profit and loss account of the Practice for the year ended 31 March 1995 are as follows:

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Fee income		1,626,420
Less	Expenses	
	Consultancy fee paid to ServiceCo2 (' the Fee')	600,000
	Accountancy fee	6,000
	Bar membership fee and practising certificate	15,894
	Business registration fee	2,250
	Donation	900
	Entertainment	185,952
	Local travelling expenses	91,250
	Share of chamber (sic) expenses	220,977
		1,123,223
Net profit		503,197

After making adjustment on depreciation allowance, the Taxpayer reported assessable profits of $500,717 in the Practice' s proposed tax computation for the year of assessment 1994/95.

7. Pending clarification of certain information the assessor raised on the Taxpayer the profits tax assessment for the year of assessment 1994/95 showing assessable profits of $500,717 with tax payable thereon of $75,107. The Taxpayer did not object against this assessment.

8. After examining the nature of the expenses of ServiceCo2, the assessor considered that the Fee charged in the accounts of the Practice should only be allowed for deduction to the extent as it reflected those costs directly attributable to the operation of the Practice plus an appropriate mark-up. The assessor disallowed $264,715 from the Fee and raised the additional profits tax assessment for the year of assessment 1994/95 showing additional assessable profits of $264,715 with additional tax payable thereon of $39,707.

9. The Taxpayer objected against the additional profits tax assessment.

The determination

10. The assessor formed the opinion that the Fee was not incurred in the production of profits of the Practice and was not deductible and that the additional profits tax assessment should be revised to show additional assessable profits of $600,000 with additional tax payable of $90,000.

11. By her determination, the Commissioner increased the additional profits tax assessment for the year of assessment 1994/95, showing additional assessable profits of $264,715 with additional tax payable thereon of $39,707 to additional assessable profits of $600,000 with additional tax payable thereon of $90,000.

The appeal hearing

12. The Taxpayer appeared in person at the hearing of the appeal. He confirmed the truth of the statements of facts in his tax representatives' letter dated 28 June 1996 and his letters dated 12 March 1997, 29 August 1997 and 27 October 2000. He was cross-examined by Miss CHEUNG Mei-fan who represented the Respondent at the hearing of the appeal.

13. After the Taxpayer had concluded his testimony and submission, we invited the Taxpayer to address us on section 68(9) of the IRO, Chapter 112. After his submission we told the parties that we were not calling on the Respondent and that we would give our decision in writing.

Our decision

14. Section 68(4) of the IRO provides that the onus of proving that the assessment appealed against is excessive or incorrect is on the appellant.

15. The Taxpayer claimed deduction of the Fee. According to Note 2 in his profit and loss account for the year ended 31 March 1995, the Fee in the sum of $600,000 was said to have been paid to ServiceCo2 ' for management and consultancy services provided to the Company (sic) at $50,000 per month' .

16. When we turn to the twelve debit notes said to have been issued by ServiceCo2 to the Taxpayer, the ' management and consultancy services' became:

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Provision of administration support	13,000

Provision of chauffeur	12,000
Provision of car	15,000
Provision of study room	10,000

17. So far as this appeal is concerned, two items of expenses in the Taxpayer' s profit and loss account stared us in the face. The first is the ' Local travelling expenses' in the sum of $91,250. The second in ' Share of chamber (sic) expenses' in the sum of $220,977. ' Entertainment' in the sum of $185,952 is an eye-opener but we are not concerned with it in this appeal.

18. ' Local travelling expenses' in the sum of $91,250 stared us in the face because in our decision, $91,250 was well in excess of the total cost of travelling by taxi to and from his office (or chambers) and law courts and from one law court to another, based on information disclosed in his fee-notes for the year of assessment 1994/95. $91,250 means $250 a day, 356 days a year. His office was in Central and the principal law court which he went to was the District Court in Wanchai. He accepted he was unable to point to any visit to a police station or ICAC in his fee-notes because there was no such visit in the year of assessment 1994/95. We ask ourselves whether it is credible that having incurred $91,250 in local travelling expenses, he incurred a further $27,000 per month on chauffeur and car? The Taxpayer said that his wife could drive at night. We are not concerned with what could have happened but with what did or did not happen. The objective fact is that in the year of assessment 1994/95, the Taxpayer and his wife lived with their three small children, a girl born in 1986, a boy born in 1990 and a baby girl born in 1993, and a domestic helper at his residence. With three small children and just one domestic helper, is it credible for his wife to drive him to and from law courts during office hours and in the middle of the night?

19. According to the Taxpayer, $220,977 was the amount he paid to another company (ServiceCo1) at his office address for his share of chambers expenses. It covered the rent for his chambers and all the staff comprising one secretary and one messenger. The secretary worked for three to five barristers in his chambers and was paid $12,000 x 13 in the year of assessment 1994/95. He claimed that he could not remember the office rental in the year of assessment 1994/95.

20. The Taxpayer' s wife did not work in his chambers. Apart from the Taxpayer' s wife, ServiceCo2 had no other employee. Without access to his chambers and not answering the telephones at his office (certainly not during office hours), we do not see how the Taxpayer' s wife could possibly look after his schedules and arrange/remind meetings with solicitors and clients. We ask ourselves whether it is credible that the Taxpayer incurred $13,000 per month on account of ' administration support' supposedly rendered by his wife, bearing in mind that the secretary who worked for the Taxpayer and two to four other barristers in his chambers was paid $12,000 x 13 in the year of assessment 1994/95 and that administration and support in chambers was provided by another service company, ServiceCo1?

21. We do not accept the Taxpayer' s assertion that he could not remember the office rental in the year of assessment 1994/95. Be that as it may, $220,977 (equivalent to $18,415 a month) paid to ServiceCo1 included office rental and all staff. We ask ourselves whether it is credible that the Taxpayer incurred $10,000 each month for the use of a ' study room' or ' second office' at his residence, hearing in mind that $18,415 each month included office rental for his primary office, his chambers?

22. The Taxpayer was evasive about when an oral agreement was allegedly reached between him and ServiceCo2. He did not even tell us whether he reached agreement with himself on behalf of ServiceCo2 or with his wife on behalf of ServiceCo2.

23. Further and in any event, the Taxpayer did not impress us as a credible witness and we reject his testimony.

24. In our decision, the Taxpayer has not proved that:

(a) he had in fact incurred the Fee;

(b) if contrary to our finding, he had incurred the Fee, the Fee was incurred in the production of profits in respect of which he was chargeable to tax.

25. His appeal therefore fails.

26. Further and in any event, section 61 of the IRO provides that:

> ' *Where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessable accordingly.'*

27. We remind ourselves of the observations made by Lord Diplock, delivering the advice of the Privy Council in Seramco Trustees v Income Tax Commissioner [1977] AC 287 at pages 297-8:

> ' *It is only when the method used for dividend stripping involves a transaction which can properly be described as "artificial" or "fictitious" that it comes within the ambit of section 10(1). Whether it can properly be so described depends upon the terms of the particular transaction that is impugned and the circumstances in which it was made and carried out.*

> *"Artificial" is an adjective which is in general use in the English language. It is not a term of legal art; it is capable of bearing a variety of meanings according to the context in which it is used. In common with all three members of the Court of Appeal their Lordships reject the trustees' first contention that its use by the draftsman of the subsection is pleonastic, that is, a mere synonym for "fictitious". A fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. "Artificial" as descriptive of a transaction is, in their Lordships' view a word of wider import. Where in a provision of a statute an ordinary English word is used, it is neither necessary nor wise for a court of construction to attempt to lay down in substitution for it, some paraphrase which would be of general application to all cases arising under the provision to be construed. Judicial exegesis should be confined to what is necessary for the decision of the particular case. Their Lordships will accordingly limit themselves to an examination of the shares agreement and the circumstances in which it was made and carried out, in order to see whether that particular transaction is properly described as "artificial" within the ordinary meaning of that word.'*

28. Just as counsel did in D44/92, IRBRD, vol 7, 324, the Taxpayer accepted that a 'commercially unrealistic' transaction came within the meaning of 'artificial' in section 61.

29. In our decision it was commercially unrealistic for the Taxpayer to incur the Fee at $50,000 per month, $27,000 of which was on chauffeur and car, in view of the fact that he had already incurred $91,250 on local travelling expenses. It was also commercially unrealistic for the Taxpayer to incur $13,000 per month on administration support said to be provided by his wife and $10,000 per month on a 'study room' or 'second office' in view of the fact that he had already incurred on average $18,415 a month to ServiceCo1 which included rental for his chambers and all the staff in chambers.

30. In our decision, the Fee is artificial within the meaning of section 61 of the IRO and is to be disregarded.

Disposition

31. The Taxpayer has not discharged the onus under section 68(4) of proving that the assessment appealed against is excessive or incorrect. We dismiss the appeal and confirm the assessment as increased by the Commissioner.

Costs order

32. As noted in a number of Board decisions, the discretion of the Board under section 68(9) to order an unsuccessful Taxpayer to pay costs is not expressed to be restricted to appeals

which are obviously unsustainable. The maximum sum was increased from $100 to $1,000 in 1985 and further increased to $5,000 in 1993. $5,000 represents only a small fraction of the costs of the Board in disposing of an appeal.

33. We are of the opinion that this appeal is frivolous and vexatious and an abuse of the process. Pursuant to section 68(9) of the IRO, we order the Taxpayer 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.