INLAND REVENUE BOARD OF REVIEW DECISIONS

**Case No. D110/98**

**Profits Tax** – deductible expenses – management fees paid to service company – sections 14, 16 and 61 of the Inland Revenue Ordinance.

Panel: Geoffrey Ma Tao Li SC (chairman), Victor Hui Chun Fui and Lily Yew Kuin King Suk.

Date of hearing: 27 May 1998.
Date of decision: 10 November 1998.

The taxpayer was a medical practitioner. He claimed that the totality of the management fees paid by him to a service company should be treated as deductible expenses under section 16 of the Inland Revenue Ordinance (the IRO). The Commissioner's position was that the service company was essentially a mere tax vehicle and its appointment was an artificial transaction. He only allowed the deduction of a portion of the management fees paid by the taxpayer.

Held:

(1) Section 61 of the IRO is to be given a fair and sensible interpretation. It is there to prevent the use of artificial of fictitious devices in order to gain a tax advantage. The word 'transaction' connotes some form of dealing. In the context of a service company, the relevant transaction is not the setting up of the company itself but the alleged dealing or dealings with the taxpayers said to give rise to the tax relief claimed.

(2) Where the agreed remuneration is a fixed fee (whether including or excluding expenses) and there is some correlation between that fee and the services provided this is at least an indication of the commerciality of the arrangement. Where, however, there is no fixed fee and there appears little correlation between the management fees charged and the services actually provided, the Commissioner is entitled to raise queries as to the artificiality of service companies.

(3) It is not the function of a service company to provide the means by which domestic and private expenses are made tax deductible. Where the employee of the service company generating these expenses is the taxpayer himself, this leaves much room for scepticism.

(4) Practice Note cannot alter the law and it is the IRO that the Board has to apply, not the Practice Note.

**Appeal dismissed.**

Chiu Kwok Kit for the Commissioner of Inland Revenue.
T M Lea of Crump & Co International Maritime and Commercial Lawyers for the taxpayer.

**Decision:**

**The issues**

1. The Taxpayer, appeals in these proceedings against a written determination by the Commissioner of Inland Revenue dated 18 April 1997. He is a medical practitioner.

2. The dispute in these proceedings revolves around the use by the Taxpayer of a service company: he claims that the totality of the management fees paid by him to a service company should be treated as deductible expenses under section 16 of the Inland Revenue Ordinance ('the IRO'). The relevant service company in the present case is a company called Company X. The Commissioner's position is that the management fees said to have been paid by the Taxpayer to Company X are not allowable in full. The Commissioner has already reduced his original assessments by deducting a portion of the management fees paid by the Taxpayer. The Taxpayer is dissatisfied with this: he wants the whole of the management fees deducted.

3. The difference between the parties can perhaps be simply stated: the Taxpayer claims that as Company X provided services to him necessary for his practice, the whole of the management fees paid to Company X are allowable expenses; whereas the Commissioner's position is that, when analyzed, Company X was essentially a mere tax vehicle and its appointment was an artificial transaction.

4. Before we identify the issues before us for decision, we would like briefly to deal with certain provision in the IRO particularly germane to the present proceedings:

(a) Section 14 of the IRO is the foundation for profits tax: tax is payable on the assessable profits of any person carrying on a trade, profession or business in Hong Kong.

(b) In ascertaining profits which are to be assessed for profits tax, there will be deducted all those outgoings and expenses incurred 'in the production of profits in respect of which' tax is chargeable: section 16.

(c) This prima facie somewhat wide provision is qualified by section 61 in that where any transaction which reduces or would reduce the amount of tax payable by any person, is artificial or fictitious, this may be disregarded. Mr Lea, for the Taxpayer, argues that this section is of no relevance when considering the position of Company X. The argument proceeds along the following lines: neither the creation of Company X nor its use by the Taxpayer was a 'transaction' within the meaning of the section; thus argued, the section is irrelevant. With respect, we reject this approach. Section 61 is to be given a fair and sensible interpretation. It is there to prevent the use of artificial or fictitious devices in order to gain a tax advantage. The word 'transaction' connotes some form of dealing. In the context of a service company, the relevant transaction is not the setting up of the company itself (as to which there cannot be any complaint) but the alleged *dealing or dealings with the taxpayer* said to give rise to the tax relief claimed that is relevant here.

5. The issues for decision can now be identified:

(a) Was Company X an artificial device and were the transactions between it and the Taxpayer artificial?

(b) Did the payments of management fees by the Taxpayer represent payments incurred by the Taxpayer in the production of profits under section 16 and if so, to what extent?

(c) The relevance of Practice Note No 24 issued in August 1995.

(d) The relevance of the paper headed 'The Way Forward' sent by the Commissioner to Dr Leong Che Hung.

**Issue 1: Was Company X an artificial device and were the transactions between it and the Taxpayer artificial?**

6. The following facts are relevant:

(a) For the years in question, Company X was a company effectively owned and controlled by the Taxpayer. He (together with two other persons) were the only directors of the company.

(b) The company was incorporated on 12 February 1985.

(c) The Taxpayer and Company X entered into a service agreement dated 1 October 1993. By this agreement, Company X was to provide all administrative and technical support services to enable the Taxpayer to carry on business as a medical practitioner. This was stated to include the provision of qualified staff, office premises and equipment, office staff, medical equipment and a medical library.

(d) Company X was set up as a tax avoidance vehicle. It was set up on the advice of the Taxpayer's accountants. Indeed, the agreement was signed on behalf of Company X by the then tax consultant for the Taxpayer. To the credit of the Taxpayer is the frank acknowledgement of this.

(e) Of particular significance always when questions arise as to the artificiality of service companies, is the amount of remuneration which is agreed between the company and the professional. Where the agreed remuneration is a fixed fee (whether including or excluding expenses) and there is some correlation between that fee and the services provided, this is at least an indication of the commerciality of the arrangement. Where, however, there is no fixed fee and there appears little correlation between the management fees charged and the services actually provided, the Commissioner is entitled to raise queries as to this.

(f) The services agreement in the present case does not fix the amount of remuneration of Company X. Instead, an annual fee is payable at the beginning of each accounting year. What happened for the years in question was the payment of management fees which, in terms of the percentage of the Taxpayer's fees, amounted to approximately 63% (for the year of assessment 1991/92), 71% (for the year of assessment 1992/93), 64% (for the year of assessment 1993/94), 61% (for the year of assessment 1994/95) and 54% (for the year of assessment 1995/96). The effect of this treatment can be starkly exemplified by the year of assessment 1994/95. The Taxpayer's position was that the total of assessable profits that year came to just $12,336, a little over $1,000 a month. Yet that year was the most lucrative as far as the Taxpayer was concerned: the gross fees amounted to some $2,921,808.

(g) By itself, the mere fact that the proportion of the management fees to the fees received appears great, would not conclude the matter if the Taxpayer could otherwise provide an adequate explanation of the role of Company X.

(h) In respect of the years of assessment 1991/92 and 1992/93, it is the Taxpayer's position that Company X functioned as a service company even though the service agreement had as yet not been concluded. At that time, it is said that the agreement between the Taxpayer and Company X was made orally: see the letter dated 26 May 1995 from Glass Radcliffe and Wee (the Taxpayer's tax representatives) to the CIR. It does strike us as odd that if the arrangements between Company X and the Taxpayer are to be treated all along as being at arm's length and commercial, only an oral agreement was seen to be sufficient at one stage. What is more of note is that for those years the Taxpayer practiced as part of a medical group. The group used a service company known as Company Y to service the practice. We have seen before us minutes of meetings of this company together with ledgers. Company Y provided staff for the clinic and appears to have rented premises as well. Each of the doctors in

the practice was billed for his share of the expenses. As far as the Taxpayer was concerned, he was billed in his own name. It is clear to us that while Company Y did provide services for the Taxpayer's practice, Company X's role is much less clear. We fail to see for those years just why it was necessary to have an individual service company for the Taxpayer at all. In evidence, the Taxpayer was somewhat imprecise about just what services Company X provided.

(i) From late 1993, the Taxpayer appears to have broken off from the group practice and practiced on his own. From this time, according to Company X's accounts, Company X provided and paid for the rental of the Taxpayer's clinic as well as staff. A number of Company X's expenses obviously relate to the Taxpayer's clinic and the Commissioner's determination confirms this. However, a number of expenses do not.

(j) What the documents do demonstrate was that while there were some legitimate expenses incurred by Company X which related to the Taxpayer's practice, almost the whole of the daily household and living expenses of the Taxpayer and his wife was charged to Company X. This included such diverse items such as parking fines, club expenses, motor expenses, credit card expenses, meals, club expenses. It is of course not the function of a service company to provide the means by which domestic and private expenses are made tax deductible.

(k) What is said is that these were expenses which were part of the package of Company X's employees and it was Company X's employees who provided the services to the Taxpayer. However, where the employee generating these expenses is the Taxpayer himself, this leaves much room for scepticism.

(l) We are also not satisfied with the assertion that a lot of the expenses relate to entertainment for the benefit of the Taxpayer's practice. No real details were provided of this.

(m) Also to be noted is the fact that generous dividends were declared by Company X over the years. For example, for the year ending 30 September 1991, a dividend of $1,000,000 was declared, for the year ending 30 September 1992 there was an interim declared of $350,000, for the year ending 30 September 1993 the interim dividend was $300,000 and the same for the year ending 30 September 1994. These dividends were presumably paid to the Taxpayer.

(n) It is clear to us that Company X was used as a tax vehicle to enable the Taxpayer to deduct the whole of his expenses, whether professional or otherwise, from his fees so as to reduce drastically his liability to profits tax. We are not satisfied that the services provided by Company X were wholly proportionate to the fees charged by the company as management fees.

7. In conclusion, while it is clear that some of the expenses of Company X did relate to the Taxpayer's practice, the interposing of Company X was in reality predominantly designed to be a tax vehicle whereby a lot of the Taxpayer's personal expenses were to be made tax deductible and, more importantly, to enable the Taxpayer to reduce his tax liability to minuscule proportions. It was hardly necessary nor even advantageous for the Taxpayer to engage Company X to provide services to his practice and certainly not at the management fee that company charged. To put it another way, if Company X was not owned by the Taxpayer and not providing him with the benefits it did (including loans on generous terms), we would not have thought there would be much if any possibility that the Taxpayer would have engaged that company. It would simply not have been commercially acceptable. Lastly, it should be noted that Company X acted only for the Taxpayer; it had no other clients.

8. Accordingly, we are of the view that Company X was essentially an artificial device and that transactions between it and the Taxpayer were artificial. The fact that certain of Company X's expenses did relate to the Taxpayer's practice does not detract from that conclusion.

**Issue 2: Did the payments of management fees by the Taxpayer represent payments incurred by the Taxpayer in the production of profits under section 16 and if so, to what extent?**

9. If follows from our conclusions on Issue 1 that not all the management fees represent payments incurred by the Taxpayer in the production of profits for the purposes of section 16 of the IRO.

10. It is not necessary for us to consider striking down the whole of the management fees paid to Company X. This possibility arises from the wording of section 61 which appears not to allow the Commissioner to disregard only a part of a transaction. It is not necessary to consider this point in view of the fact that Commissioner has revised his original assessments to take into account those legitimate expenses of Company X relating to the Taxpayer's practice.

11. In any event, a consideration of section 16 allows us to determine the extent to which expenses or outgoings can be deducted.

12. In view of our conclusions above, we are of the view that the Commissioner has already in his determination taken into account the full extent of the deductions allowable to the Taxpayer under section 16. The Taxpayer has not satisfied us that any further part of the management fees paid to Company X should be allowed.

**Issue 3: The relevance of Practice Note No 24 issued in August 1995**

13. The Practice Note deals with service companies and represented when it was issued a tougher line taken by the Commissioner. Paragraph 29 of the Practice Note states, however, that an assessment which in the absence of the Practice Note would have regarded

as final and conclusive in terms of section 70 of the IRO would not be reopened. That paragraph is inapplicable in the present case. The assessments which are the subject matter of the present appeal were not final and conclusive. In any event, the Practice Note cannot alter the law and it is the IRO that we have to apply not the Practice Note.

**Issue 4: The relevance of the paper headed 'The Way Forward' sent by the Commissioner to Dr Leong Che Hung**

14. In a paper headed 'The Way Forward' from the Commissioner to Dr Leong (in his capacity as the representative of the medical functional constituency), the Inland Revenue's stated position on service companies was, 'In reviewing the non-understatement cases, that is, where there is no suspected understatement of gross takings and where the service company is actually in operation, no re-opening of back years will be made unless the management fee exceeds 70% of the consultation fees and other receipts making up the practice's gross taking.'

15. In the present case, there is no question of this percentage figure having been exceeded. However, just as in the case of Practice Note No 24, we have to apply the law and the IRO. In any event, the effect of the paper was qualified by a letter from the Commissioner to Dr Leong dated 8 October 1996.

**Conclusion**

16. For the above reasons, we dismiss the appeal.