Case No. D128/01

Profits tax – whether certain sums were deductible as outgoings and expenses – two criteria to be satisfied before deduction is allowed under section 16(1) – firstly, it must be incurred in the production of assessable profits and secondly, it must be incurred during the basis period for the relevant year of assessment – mere compliance with section 16(1) is not sufficient, it must also not be excluded under section 17(1) – sections 16, 17 and 68(4) of the Inland Revenue Ordinance ('IRO').

Panel: Anna Chow Suk Han (chairman), Thomas Mark Lea and William Zao Sing Tsun.

Date of hearing: 28 February 2001.
Date of decision: 31 December 2001.

The taxpayer, trading as Company B, appealed against a determination of a profits tax assessment for the year of assessment 1997/98. She claimed that an investigation fee of $2,400,000 and a provision for exceptional loss of $45,113,857 should be deducted from her assessable profits.

The issues on appeal were:

1. whether the said investigation fee of $2,400,000 and the said provision for exceptional loss of $45,113,857 would qualify as deductions under section 16;

2. if so, whether these sums would be excluded under section 17.

Held:

1. The onus of proving that the assessment appealed against is excessive or incorrect shall be on the taxpayer (section 68(4)).

2. Whether an expense is an allowable deduction is governed by sections 16 and 17 of the IRO.

3. The deduction of outgoings and expenses is governed by section 16(1) of IRO. It contains the general rule relating to the permissibility of making deductions for the purpose of ascertaining assessable profits. The effect of this subsection is that it

permits deduction of all outgoings and expenses which satisfy two criteria, namely (1) they must be incurred in the production of assessable profits and (2) they must be incurred during the basis period for the year of assessment in question. It matters not if such outgoings or expenses are incurred for the production of profits not in the year of assessment in which the outgoings and expenses are incurred but in some other periods.

4. On the other hand, section 17 sets out the various types of outgoings and expenses which are not permissible. Of particular relevance in this appeal were subsections (b) and (e) thereof.

5. It was only when the said two items, that is, an investigation fee of $2,400,000 and a provision for exceptional loss of $45,113,857, qualified under both sections 16 and 17 would deductions be allowable.

6. The statutory provisions in the United Kingdom were similar but not the same as those in Hong Kong.

7. The Board found that the investigation fee was a disbursement expended by the taxpayer in the year of assessment in question. As to the other criterion for permissibility of deduction under section 16(1), the Board held that the fee was incurred in the course of the taxpayer's business for purpose of production of profits. To enable herself to continue her business as a securities dealer, the taxpayer had to comply with the direction of the Stock Exchange and to carry out the investigation.

8. While satisfying the two criteria under section 16(1), the investigation fee was also not excluded under section 17(1). Thus, the Board found this item of expense qualified as a deduction for the purpose of ascertaining the assessable profits of the taxpayer in the year of assessment in question.

9. Mismanagement of business and breaches of regulatory rules on the part of the taxpayer should not affect the interpretation of sections 16 and 17 of the IRO which determine when an expense is an allowable deduction.

10. As to the second item of expenditure claimed for deduction, that is, the provision for exceptional loss, this item was a provision only and it was not actually paid out in the year of assessment in question.

11. The Board derived assistance from the case of Lo & Lo v CIR in deciding whether a 'provision for payment' was a deductible expense. If a taxpayer had an accrued liability, whether legal or practical, for payment of the exceptional loss in the year of assessment in question, the taxpayer's provision for the exceptional loss would

qualify as a deductible expense even though the exceptional loss was not actually paid out in the year of assessment in question.

12. The Board found that the firm’s liability in the Lo & Lo case was distinguishable from the liability of the taxpayer in the present case.

13. The Board found that the taxpayer did not have an accrued liability, legal or practical, for payment of the exceptional loss in the year of assessment in question.

14. Even if the Board were to find that the taxpayer had an accrued liability for the payment of the exceptional loss in the year of assessment in question, the taxpayer’s claim would still fail on the subsidiary question, because the exceptional loss could not be allowed for the reason that it was not an adequately measured appraisal of the liability.

15. Had the exceptional loss been incurred, the Board would find that it was incurred in the course of Company B’s business for the production of assessable profits for the same reason the Board had found in respect of the investigation fee.

16. Since the provision for exceptional loss does not qualify for deduction under section 16(1), the Board needed not concern itself with section 17. Had it been necessary for the Board to do so, it would say that the provision of section 17(1)(e) should apply and the exceptional loss should be reduced by such amount as recoverable under the policy of insurance.

17. For the aforesaid reasons, the appeal was allowed in relation to the investigation fee and was dismissed in relation to the provision for exceptional loss.

18. The taxpayer’s representatives submitted to the Board that if the appeal failed, the amount of $5,114,462 and any future amount payable in settlement of claims should be allowed as deductions in ascertaining the taxpayer’s profits for the period ended 6 May 1999, the date of cessation of business, under section 15D(2) of the IRO. Since the assessment under appeal was in relation to the year of assessment 1997/98, the Board had no jurisdiction over the taxpayer’s tax liabilities of other assessment years and thus the Board was unable and would not make a ruling thereon.

19. In reaching the decision on the deductibility of the exceptional loss and the investigation fee, the Board needed not and did not take into account such part of the evidence of Mr N, an expert witness for and on behalf of the taxpayer, as disputed by the Commissioner. Thus, there was no need for the Board to make a ruling on the admissibility of such part of the evidence of Mr N.

20. The Board put on record that Mr N' s professionalism or competence was in no way undermined in the course of this appeal.

Appeal allowed in part.

Cases referred to:

Strong & Company of Romsey Ltd v Woodifield 5 TC 215
Fairrie v Hall 28 TC 200
Wharf Properties Limited v Commissioner of Inland Revenue 4 HKTC 310
Sweetman v CIR [1996] 34 ATR 209
McKnight v Sheppard [1997] BTC 328
Lo & Lo v CIR [1984] HKTC 34

Wong Kuen Fai for the Commissioner of Inland Revenue.
Steven Kwan Kar Chun of HLB Hodgson Impey Cheng, Chartered Accountants, Certified Public Accountants, for the taxpayer.

Decision:

The appeal

1. This is an appeal by Ms A ('the Taxpayer') trading as Company B against the profits tax assessment raised on her for the year of assessment 1997/98. The Taxpayer claims that an investigation fee of $2,400,000 and a provision for exceptional loss of $45,113,875 should be deducted from her assessable profits.

The finding of facts

2. Based on the statement of facts submitted and the documentary and oral evidence before us, we find the following facts admitted or proved.

3. At the material times, the Taxpayer was a securities dealer registered with the Securities and Futures Commission ('SFC') and was a member of the Stock Exchange of Hong Kong Limited ('SEHK'). She carried on her business under the name of Company B having its head office in District C and a branch office at District D ('the District D branch').

4. By a letter of 28 February 1996 from SEHK to Company B, Company B was informed of its various breaches of the Securities Ordinance ('SO') and the rules of SEHK and a number of its internal management weaknesses. It was required to rectify those breaches and weaknesses as a matter of priority, without prejudice to any disciplinary action which SEHK might bring against it.

5. On 12 August 1997, SFC and SEHK made a press release that they had received a number of complaints from various investors following the closure of Company B's District D branch and the disappearance of its branch manager Mr E. It was announced inter alia that their first task was to establish the extent of the losses incurred by Company B so as to ensure Company B having sufficient resources to meet its liabilities and the ability to continue trading and being in full compliance of the applicable financial resources rules.

6. On 16 September 1997, pursuant to the direction of SEHK, Company B jointly with SEHK engaged a consultancy firm Company G to conduct a review of the alleged irregular activities of Mr E. The objectives of the engagement were:

(a) to review the potential claims, if any, against Company B by its clients and other alleged claimants arising from the alleged irregular activities of Mr E.

(b) to review the management, supervision and internal controls of Company B and the way in which they had been and were being operated in relation to the activities of the District D branch and to report thereon;

(c) to identify weaknesses, if any, in Company B's management, supervision and internal controls in relation to the District D branch and to report on the weaknesses which might have contributed to the alleged irregular activities in the District D branch; and

(d) if appropriate, to recommend improvements consequent thereon.

7. SEHK and Company B subsequently revised the terms of Company F's engagement to the extent that it would be no longer relevant to review the management, supervision and internal controls in relation to the District D branch or to recommend improvements thereon, due to the fact the District D branch was closed as from 11 August 1997 and would not be reopened.

8. On 8 January 1998, Company F submitted a report to SEHK and the Taxpayer. The report provided, inter alia, the particulars of the Taxpayer's various breaches of the SEHK rules and the SEHK Code of Conduct Regulations, and provisions under the SO and also the following particulars:

(a) According to Company B, the District D branch which was opened in 1983 and was its only branch, accounted for 5% of the entire securities business of Company B as at 31 March 1997.

(b) On 8 August 1997, a claimant visited the Company B head office and complained that Mr E had failed to settle his balance despite repeated requests.

(c) On 11 August 1997, many persons claiming to be clients of the District D branch contacted the head office to confirm stock positions and monetary balances. According to Company B, some of the claimants brought along shares deposit temporary receipts ('SDTRs'). Company B discovered that the head office did not have records for many of these claimants. The matter was reported to police.

(d) SEHK conducted an inspection of Company B during October 1995. In the management letter dated 28 February 1996, SEHK made a number of comments on Company B's operations. One of the comments was that on certain occasions, Company B had transferred clients' securities without obtaining their written instruction. SEHK noted that these transfers were authorized by Mr E.

(e) Notwithstanding the comments by SEHK, Company B had failed to strengthen the control procedures adequately to protect its clients and its own position from financial loss arising from fraud and other dishonest act.

(f) Company B held assets of a total value of $18,273,798 (including shares and cheques totalling $9,564,129 in the names of Mr G and Mr E) for the District D branch as at 11 August 1997. These assets should be available for settlement of valid claims submitted.

(g) The value of the claims submitted by the claimants as at 11 August 1997 was $46,300,000 (representing gross claims of $48,600,000 less unsettled balances owned by the claimants of $2,300,000). When the value of the assets held by Company B for the District D branch was deducted from the value of the claims, the maximum exposure of Company B was approximately $28,000,000.

(h) The claims were categorized into four major categories:

Category A – claims that matched with Company B's internal records;
Category B – claims that are supported by SDTRs;
Category C – claims that are not supported by SDTRs; and
Category D – other claims

They were detailed in the body of the following table:

Category	Description	Number of claim items	Total value of claims $	Total payable to Company B $
A1	Whole account confirmed by Company B	47	2,192,813	-
A2	Claim items matched with scrip kept in the District D branch	8	286,542	-
A3	Claim items matched with Company B's computer stock records	43	2,966,540	26,049
B1	With SDTRs and supported by bank records - payments to Company B - payments to/from Mr E or his associate(s)	 145 58	 11,177,163 9,547,111	 - -
B2	With SDTRs and could be traced to bank records indirectly - payments to Company B - payments to Mr E or his associate(s)	 19 6	 731,385 355,100	 31,798 -
B3	With SDTRs and could not be traced to bank records	217	9,234,131	421,101
C1	Without SDTRs but supported by bank records - payments to Company B - payments to Mr E	 2 4	 72,400 146,000	 - -
C2	Claims for sale proceeds with SDTRs supported by bank records - payments to Company B - payments to/from Mr E or his associate(s)	 19 4	 2,532,613 497,955	 - -
C3	Without SDTRs but with bank records of previous payments - payments to Company B - payments to/from Mr E or his associate(s)	 9 3	 378,588 343,500	 84,877 62,155
C4	Without SDTRs and bank			

	records	85	7,115,436	1,644,893
C5	Claims for net trading balances	9	229,562	-
D	Other claims	10	802,911	-
	Total	688	48,609,750	2,270,873

(i) The review by Company F did not cover the legal aspects relating to the claims and should not be solely relied on to determine the legal responsibilities and other obligations that Company B might have in relation to the claims.

9. To ensure that Company B was financially viable to maintain its operation without the need to suspend its trading, Company B was requested by SEHK and SFC to, inter alia, make provision for all potential claims based on claims received from the clients.

10. By a letter of 28 August 1998, Company B informed SEHK that the value of the outstanding claims after deducting those of Categories A and C(5) was $10,037,701 and that its outstanding exposure had been lowered since some outstanding claims were not substantiated; the insurer was prepared to settle claims of $8,000,000; and shares of an amount over $5,000,000 had been purchased for settlement of the claims. It also sought approval to reduce the provision for liabilities form $48,600,000 to $10,000,000 since the provision was substantially higher than reality.

11. By its letter of 23 September 1998, SEHK gave its approval to Company B to reduce its provision for exceptional loss to $28,800,000, after taking into account the value of the shares withheld.

12. The Taxpayer submitted insurance claims to Solicitors' Firm H who acted on behalf of the insurance company. The first claim was made on 6 January 1999, for $1,212,980.02 of which after deduction of $200,000, the double deductible applicable to the claim, a sum of $1,012,980.02 was paid to the Taxpayer on 3 August 1999.

13. The Taxpayer purchased shares of settlement of the clients' claims. According to the Taxpayer' s tax representatives, as at 5 February 2001, she incurred the amount of $6,127,441.8 being the cost of the replacement shares less the amount recovered from some clients. The net loss claimed by the Taxpayer under the policy of insurance was $5,114,461.78 as at 5 February 2001, being $6,127,441.8 less $1,012,980.02, the sum recovered on 3 August 1999.

14. It was submitted the Taxpayer's tax representatives in their letter to the Board of 7 February 2001 that there were claims from clients who refused to accept replacement shares as compensation for loss but sought compensation based on the original purchase prices of the shares and the value of those claims basing on the market value of the replacement shares as at 17 January 2001 came to $8,169,385. The Respondent produced a copy writ, where by a High Court Action No XXXX of 1999, the Taxpayer was sued by a plaintiff named Mr I for failing to deliver up shares

and balance of proceeds on or about 11 August 1997, arising out of Mr E's fraud and/or conversion. A defence of 20 May 1999 was filed by the Taxpayer, in respect of this claim.

15. In their letter of 7 February 2001, the Taxpayer's tax representatives informed the Board that with the benefit of hindsight, they considered that the loss incurred by the Taxpayer for the year of assessment 1997/98 was $14,296,826.8 being the total of $6,127,441.8 and $8,169,385.

16. According to the records compiled and submitted by the Taxpayer's tax representatives on 7 February 2001, the replacement shares were bought by the Taxpayer between 22 January 1998 and 29 November 2000, and settlement of the clients' claims commenced on 25 May 1998.

17. SEHK heard the cases and found the charges preferred against the Taxpayer and her authorized clerks, Mr J and Ms K proved.

18. The substance of the charge proved against the Taxpayer was that the Taxpayer was deficient in developing and implementing adequate management, supervision and control over the operation of Company B's District D branch resulting that the branch office manager of the District D branch had misappropriated clients' securities and funds in August 1997. The substance of the charge proved against Mr J was that Mr J who was ultimately responsible for all cash clients and the securities business of Company B, did not adequately supervise Company B's securities business to the extent of preventing Company B from possible theft or fraud by its employee. The substance of the charge proved against Ms K was that Ms K who was responsible for Company B's settlement matters and had contributed but to a lesser extent than Mr J to the misappropriation of clients' securities and funds by the branch office manager.

19. The disciplinary committee of SEHK resolved that a penalty of public censure plus a fine of $40,000 be imposed on Ms A and a penalty of public censure plus a fine of $25,000 be imposed on each of Mr J and Ms K.

20. In order to comply with a term of the settlement of the disciplinary action against her, the Taxpayer ceased her business on 6 May 1999, and Company B was incorporated into a limited company named Company L which was registered with SEHK as a corporate member. The company took over Company B's business and liabilities as at 6 May 1999, which included payment of compensation to the clients who claimed to have lost their money or shares through the District D branch.

21. In its profits and loss accounts ended 31 March 1998, Company B included a provision for exceptional loss of $45,113,875 and an expense item of investigation fee of $2,400,000.

22. At the material time, the Taxpayer insured against losses under the brokers fidelity insurance scheme operated by SEHK. Under the terms of the insurance policy, the Taxpayer would be indemnified against certain types of losses to be incurred in the course of carrying on the business of a securities broker. Those losses included, inter alia, loss and legal liability to third parties sustained as a direct result of dishonest or fraudulent acts of employees and liability to third parties caused by inability to complete transactions entered into in the course of its business activities due to (inter alia) physical loss, destruction, theft or damage of securities and cash and deception as to a person's identity for the purpose of buying or selling of securities. The aggregate limit of the indemnity under the policy of insurance was $9,000,000 for any one claim or in all and there was an excess amount of $1,000,000.

23. Mr M gave evidence on behalf of the Taxpayer. He was employed by Company B as an assistant manager since 10 July 1995 and was responsible for accounting and general administration duties. When Company F conducted the review of Mr E's alleged irregular activities at the District D branch in September 1997, Mr M assisted in the review, by providing Company F with the accounts opening forms and claimants details, explaining to Company F the daily operation at the head office and corresponding with and reporting to SEHK. Mr M handled claims from clients who alleged to have lost their shares through transactions at the District D branch. In respect of those claims under Categories A and B, he checked the amounts of dividends, bonus shares, split or conversion of shares claimed to have been lost by those clients and prepared those particulars for approval by the management of Company B. Upon receipt of approval, he withdrew the shares from the Central Clearing and Settlement System and made appointments with the claimants for collection of shares and settlement of their claims. In respect of claims under Categories C and D, he requested for further evidence from the claimants before he submitted their claims for the management's approval. After approval of claims by the management and collection of shares and dividends by the claimants, he then prepared the necessary documents for filing with the insurance company through Solicitors' Firm H. If required by the insurance company he would supply it with further information.

The Taxpayer' s case

24. The Taxpayer' s grounds of appeal were as below.

25. The Commissioner erred in disallowing as a deduction under section 16(1) of the IRO the provision for exceptional loss $45,113,875 and the investigation fee of $2,400,000 which were expenses incurred in the production of assessable profits. The loss was not a potential loss but a loss based on the claims made by the Taxpayer's clients as assessed by Company F. The Taxpayer was committed to this loss.

26. In the securities brokerage business, it was a normal practice for a client to place orders for sale and purchase of shares through his broker' s employees. The commission and brokerage fees arising out of those transactions would form part of the broker' s assessable income. Thus, the

loss in question was a loss or liability incurred by the Taxpayer through the actions of her employee in the course of carrying on the business of a securities dealer for production of assessable income.

27. Even with strong internal control or stringent procedures, the business of a securities dealer by its own nature, was susceptible and readily exposed to risks of losses through the actions of its employees such as embezzlement, larceny, defalcation, negligence and misappropriation. Those risks were natural incidents of the business of a securities dealer.

28. The investigation by Company F was conducted partly to ascertain the loss sustained and partly to find ways to improve Company B's internal control system. Thus, the fee was also incurred in the course of carrying on the business of Company B and should be tax deductible.

29. As submitted by the Commissioner in fact (13) of the statement of facts, claims of $3,252,117 and $5,061,734 were admitted by the Taxpayer during the year ended 31 March 1998 and paid by the Taxpayer subsequently. The Taxpayer's financial statements ended 6 May 1999 showed that shares of a total value of $5,722,247 were purchased for settlement of her clients' claims. No deductions of the said amount were claimed in her tax computation for the years of assessment 1998/99 and 1999/2000.

30. Apart from avoiding legal action to be taken against her, by compensating her clients the Taxpayer was also maintaining goodwill and business relationship with her clients. As the loss was incurred in the year of assessment 1997/98, it should be allowed in the same year of assessment.

31. The written submission of the Taxpayer's tax representatives is summarized as follows.

32. The Taxpayer could not have carried on her business without making good the losses suffered by her clients through the wrongful acts of Mr E. Mr E was employed by the Taxpayer for the purpose of producing income. The Taxpayer derived income from Mr E's wrongful acts. The loss was thus in the course of the Taxpayer's carrying on her business for production of income.

33. Although the Taxpayer was deficient in the internal control of her business, she was not reckless in running it.

34. All internal control systems had their own limitations. There was no perfect control in a system. Internal control weaknesses should be regarded as risks associated with the business.

35. The Commissioner had taken the wrong tests in determining the deductibility of the loss incurred by the Taxpayer. The test was not whether the remedial actions taken by the Taxpayer after the SEHK's warning were sufficient and proper for the purpose, or whether the Taxpayer had breached securities rules or regulations. The test should be whether or not the loss was incurred in the course of carrying on a business for production of the Taxpayer's income.

36. The Code of Conduct Regulations as set out in the Seventh Schedule to the Rules of SEHK were guidelines to the securities dealers. They served as a code of conduct to be observed by securities dealers and were not meant to be complied with as law. The rules were suitable for companies of large scale but not realistic for small ones to which SFC's routine inspections were more practical. Furthermore, rules and regulations changed constantly.

37. The Taxpayer had taken steps to implement remedial measures at the District D branch after SEHK's warning letter of 28 February 1996.

38. The Taxpayer's insurer accepted the Taxpayer's claims as losses incidental to her business, resulting from the dishonest and fraudulent acts of her employee.

39. Both the cases, Strong & Company of Romsey Ltd v Woodifield 5 TC 215 and Fairrie v Hall 28 TC 200 citied by the Respondent were United Kingdom authorities in which a different test applied. In the United Kingdom legislation, for an expense to be deductible, the test was whether it was 'wholly and exclusively expended for the purpose of trade, …' while in the IRO, the test to be applied was whether the expenses were incurred in the production of profits.

The Respondent's case

40. The assessor disallowed the provision for exceptional loss and the investigation fee for the following reasons:

(a) The investigation fee was incurred for the purpose of a special management audit directed by SEHK because of a suspected crime. It was not incurred for the production of assessable profits but for the protection of the company's asset – the SEHK membership.

(b) The sum of $45,113,875 was a provision for an expected loss incurred in the operation of a branch. It was not incurred in the normal business activities but was a provision for claims made against the Taxpayer as a result of a suspected crime.

41. By a determination of 5 September 2000, the Commissioner confirmed the assessment raised by the assessor. The Commissioner did not accept that the expected loss arose in the ordinary course of trade. She was of the view that the expected loss was caused by the Taxpayer's failure to take proper remedial actions after SEHK's warnings. Such failure could not be regarded as incidental to the carrying on of the Taxpayer's business as a stock broker. Nor could it be regarded as an unavoidable risk in the course of business. As to the investigation fee, she took the view that it should be disallowed on the same footing as the expected loss, in that the reason for incurring the fee was to investigate the irregular activities of Mr E. It could not be said that the purpose of the investigation was to improve Company B's internal control, especially when Company B ceased business 19 months after the investigation. The investigation fee was incurred in

relation to the expected loss, even though the investigation might eventually lead to improvement in Company B's internal control.

42. It was also submitted to the Board as follows.

43. The exceptional loss was not incurred in the production of profits. Embezzlement, theft or loss arising from the misconduct or dishonest act of an employee was not a normal occurrence in carrying on of a business.

44. The exceptional loss was a provision only. No payments had actually been made to the Taxpayer's clients during the year of assessment.

45. The Taxpayer was in breach of the rules and regulations imposed on securities dealers. Had the Taxpayer effected proper supervision, the irregularities could not have escaped the attention of the management.

46. In their report, Company F had identified control weaknesses in many areas. Based on the findings of their limited review, Company B failed to effectively rectify the internal control weaknesses and was in breach of the relevant laws and regulations previously pointed out by SEHK.

47. SFC also raised concerns on the extensive failings in Company B's internal controls and supervisory practices.

48. The underwriter of the Taxpayer's insurer had doubled the deduction to $200,000 because there was evidence that the Taxpayer had breached the trading rules.

49. It would be against public interest to allow the deduction of the two sums because by allowing the deduction, the Taxpayer's malpractice would be subsidized by the public coffer.

50. The fraudulent act of Mr E was not a natural incident in an income derivation process. There was no evidence that the Taxpayer had to conduct her business in such a manner in order to make profits.

51. The purpose of making the provision by the Taxpayer was to enable the Taxpayer's children to stay in the securities business and to protect the Taxpayer from impeachment from the regulatory authorities.

52. The investigation fee was objected to for the same reasons as those advanced in respect of the exceptional loss. The expense was incurred for the purpose of investigating the irregular activities at the District D branch but not for improvements on the internal control of Company B.

53. Alternatively, should the Board allow the deduction, part of the loss was covered by the indemnity from the brokers fidelity insurance scheme which should be excluded as non-deductible by virtue of section 17(1)(e) of the IRO.

The statutory provisions

54. The deduction of outgoings and expenses is governed by section 16(1) of the IRO which reads as follows:

> ' *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...*'

55. Section 17(1) prohibits the deduction of certain outgoings and expenses. Of particular relevance is subsections (b) and (e) which reads:

> ' *For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of –*
>
> ...
>
> *(b) subject to section 16AA, any disbursements or expenses not being money expended for the purpose of producing such profits;*
>
> ...
>
> *(e) any sum recoverable under an insurance or contract of indemnity;*'

56. In relation to the burden of proof on appeal to the Board of Review, section 68(4) provide:

> ' *The onus of providing that the assessment appealed against is excessive or incorrect shall be on the appellant.*'

The legal authorities

57. The Respondent citied to us the following authorities:

(a) <u>Strong v Woodifield</u> 5 TC 215

(b) Fairrie v Hall 28 TC 200

(c) Wharf Properties Limited v Commissioner of Inland Revenue 4 HKTC 310

58. In the Strong case, a brewing company, which also owned licensed houses, in which they carried on the business of innkeepers, incurred damages and costs on account of injuries caused to a visitor staying at one of their houses by the falling in of a chimney. It was held that the damages and costs were not a loss 'connected with or arising out of' the business as brewers and were therefore not allowable as a deduction in computing the company's profits for income tax purposes. The deduction failed because the deduction was not a disbursement or expense wholly and exclusively laid out or expended for the purpose of the company's trade as a brewer.

59. In the case of Fairrie v Hall, Macnaughten J followed the decision in the Strong case and held that the damages and costs awarded against Mr Fairrie, a sugar broker, in a libel action brought against him by his business rival, Mr Rook, was not a loss 'connected with or arising out of the trade'. The loss had fallen upon Mr Fairrie in the character of a caluminator of a rival sugar broker and it was only remotely connected with his trade as a sugar broker.

60. In the Wharf case, the taxpayer and Hong Kong Tramways Limited ('Tramways') were both wholly-owned subsidiaries of Wharf (Holdings) Limited. Tramways operated a tram service from a depot used by it under a licence. In 1987, the taxpayer entered into an agreement to purchase the depot and the purchase was expressed to be for the purpose of redevelopment of the depot and subject to a license granted to Tramways to continue to use the depot until the delivery of vacant possession. On 21 March 1989, the taxpayer took possession of the depot and commenced the redevelopment. The purchase money was financed entirely by short term loans from banks and financial institutions with terms ranging from a week to a month. Interest expenses incurred up to and including 20 March 1989 for the years of assessment 1987/88 and 1988/89 were treated by the taxpayer as operating expenses and claimed as allowable deduction in arriving at its assessable profits for those years. During the same periods, the taxpayer received license fees from Tramways. The Commissioner of Inland Revenue determined that the interests in question should only be allowable to the extent of the licence fees from Tramways. The taxpayer appealed against the Commissioner's determination directly to High Court. At the High Court, evidence adduced by the taxpayer showed that its intention was to retain the depot for redevelopment and as a long term investment. The licence fee to be received for the use of the depot before its redevelopment played very little or no part in the decision to acquire the depot. Counsel for the taxpayer argued that interests paid in these years should be allowed as a deduction under section 16(1)(a) of the IRO because they were revenue in nature and had been incurred in the production of immediate and future rental income and that interest was never capital and could not be excluded under section 17(1)(c) of the IRO. Counsel for the Commissioner submitted that the interest expenses paid by the taxpayer were incurred for a purpose unrelated to the earning or gaining of the rental income during the 20 months' period, and that they were not incurred for the purpose of

producing assessable profits for the taxpayer's business but merely enabling the Wharf Group to make exempted profits from depositing the borrowed funds offshore and alternatively, the interest expenses were expenditure incidental to the redevelopment of the depot, which was an exercise in accretion to a capital, so that the interests paid were capital in nature. It was concluded that on the facts and circumstances of the case the interest expenses must be regarded as an expenditure of a capital nature and fell within section 17(1)(c). The High Court held that the interest payments fell to be included under section 16(1)(a), although they were incurred for the production of assessable profits in future years. However, they were held to be excluded under section 17(1)(c). As to section 17(1)(c), the trial judge was of the view that one had to examine not only the status or nature of the expenditure but also the reason or purpose for which and the circumstances under which it was incurred and he held that the interest payments were incurred for a capital purpose. The appeal was thus dismissed. Being dissatisfied with the High Court's judgment, the taxpayer lodged an appeal to the Court of Appeal. The Court of Appeal concurred with the findings and conclusion of the High Court judge and upheld the judgment. The taxpayer appealed to the Privy Council. The Privy Council dismissed the appeal and held that the loan was clearly being applied for the purpose of acquiring and creating a capital asset rather than holding it as an income-producing investment and it followed that the interest was being expended for a capital purpose.

61. The Taxpayer's tax representatives citied to us the following authorities:

(a) Sweetman v CIR [1996] 34 ATR 209

(b) McKnight v Sheppard [1997] BTC 328

(c) Lo & Lo v CIR [1984] HKTC 34

62. Sweetman v CIR was a case of an appeal to the Supreme Court of Fiji from a decision of the Court of Appeal. The Supreme Court granted the taxpayer special leave to appeal and allowed the appeal. It was held:

(a) The risk of misappropriation by a partner in a business or profession is these days a natural incident of the carrying on of a business or profession and, in that respect, is not to be distinguished from the risk of theft by an employee in a business.

(b) Although the immediate purpose of the payment was to discharge what was a personal liability, it was a partnership liability and was incurred in the capacity of a partner. The fact that the liability was personal does not give the disbursement a character or purpose which is independent of the conduct of the professional practice of the taxpayer and his partners. The personal purpose served was an integral element in the professional purpose which the disbursement served.

63. McKnight v Sheppard was a case of an appeal by the taxpayer, a stockbroker, against the decision of Lightman J [1996] BTC 355 that the legal costs incurred by the taxpayer in defending allegations of infringement of Stock Exchange rules were not deductible from his profits for the purposes of income tax because although the legal costs were wholly and exclusively incurred for the purpose of the taxpayer's trade within section 130(a) of the Income and Corporation Taxes Act 1970, there was no sufficient degree of connection between the expenditure and the profit-earning trade activity within section 130(e). The taxpayer's appeal was allowed and the commissioner's determination was restored. It was held in the appeal that a two-stage test of whether the expenditure had been wholly and exclusively incurred for the purpose of trade, and whether the expenditure was sufficiently connected with the carrying on and earning of profits in the trade, was not to be applied. The correct approach was to apply the first element only as required by section 130(a).

64. In the case of Lo & Lo, the taxpayer was a firm of solicitors. Prior to 1977, it operated an ex gratia system for the payment of retirement benefits to its employees. On 3 January 1977, it introduced a new term into the conditions of employment of its staff. Under the new term, the employees who completed ten years of service would become entitled to a lump sum payment upon retirement, which was to be based on the final salary of the retiring employee, subject to disqualification in the event of dismissal for cause. In the year 1977, the firm actually paid out $93,102 to employees retired in that year. In its profits tax return for the year of assessment 1977/78, it also sought to claim for a deduction of 'Provision for Staff Retirement Benefits' in the amount of $770,000, representing its obligation as at 31 December 1977 to the serving employees who had already qualified for such benefit. The Commissioner allowed the actual payment but refused to allow the provision on the basis that it did not all within the phrase '... expenses incurred during the basis period ...' under section 16(1). The Board of Review upheld the Commissioner's refusal to allow the provision, although it accepted the taxpayer's contention that the calculation of the provision was 'reasonably accurate' in the circumstances. The taxpayer appealed to the High Court, which reversed the Board's decision. The High Court's decision was upheld by the Court of Appeal. The Commissioner appealed to the Privy Council. The Privy Council dismissed the appeal and held that:

(a) Under section 16, deductions are not confined to sums actually paid by the taxpayer. As the employee who qualified for the benefit had a vested right to his lump sum payment, the firm had an accrued liability for that sum. Such liability was therefore considered to be admissible as an 'expense incurred' in the year 1977. To disqualify it would be placing an unduly narrow construction on section 16.

(b) No question of discounting the provision arose. The conclusion of the lower courts that the sum was sufficiently accurate was not open to challenge.

The decision

65. The Taxpayer's case is that both items of claim were expenses incurred in the course of carrying on the business of Company B as a securities dealer for the purpose of production of profits and they should be deductible for profits tax purpose and the fact that the Taxpayer had breached regulatory rules should not be a factor to be taken into account in determining the deductibility of those items.

66. On the other hand, while the Respondent agreed that when a person carried on business, he would be exposed to risks of embezzlement, theft and losses arising from misconduct or dishonest act of his employees, he did not agree that all the losses arising from those risks were tax deductible. He contended that only those expenses incurred for production of chargeable profits would qualify for deduction and that the Taxpayer's losses resulting from mismanagement of her business and breach of regulatory rules were not expenses incurred for the production of profits. The Respondent argued that in determining the deductibility of an expense, one should examine the circumstances under which the expense was incurred. In this respect, he relied on the Wharf case for support. The Respondent also submitted that for a loss to qualify for deduction, it had to satisfy the conditions that 'the risk was inherent, the loss was unavoidable and the trade must be systematically exercised'. He referred us to the Sweetman case in this regard. Furthermore, he contended that the 'exceptional loss' was only a provision which had not been paid out in the year of assessment and should not be allowed as a deduction.

67. Before we proceed, perhaps we should mention that at the hearing the Respondent accepted that the same legal principles applied to both items of claim, for the purpose of deductibility and as confirmed by her tax representatives, the Taxpayer was prepared to reduce the provision for exceptional loss from $46,000,000 to $28,000,000.

68. Whether an expense is an allowable deduction is governed by sections 16 and 17 of the IRO. Section 16 sets out the criteria for determining the type of outgoings and expenses which are allowed as deductions in computing assessable profits as well as by way of inclusion the various types of deductions which are permissible. Section 16(1) contains 'the general rule' relating to the permissibility of making deductions for the purpose of ascertaining assessable profits. The effect of this subsection is that it permits deduction of all outgoings and expenses which satisfy two criteria, namely (1) they must be incurred in the production of assessable profits and (2) they must be incurred during the basis period for the year of assessment in question. It matters not if such outgoings or expenses are incurred for the production of profits not in the year of assessment in which the outgoings and expenses are incurred but in some other periods. On the other hand, section 17 sets out the various types of outgoings and expenses which are not permissible.

69. Thus, the issues for our determination are:

(a) whether the two items, the provision for exceptional loss and the investigation fee, would qualify as deductions under section 16; and

(b) if they were, whether they would be excluded under section 17.

It follows that if the two items do not qualify as deductions under section 16, we need not go further to consider whether they would be excluded under section 17 for they are not allowable deductions. However, even if they fall within section 16, we still need to consider whether they would be excluded under section 17. Only when they qualify under both sections 16 and 17, they are allowable deductions.

70. In reaching our decision, we have carefully considered all the documentary and oral evidence before us, the authorities cited to us as above mentioned and the contentions of both parties. We were referred to the decisions in Stong v Woodified and Fairrie v Hall by the Respondent for the legal principles in determining the deductibility of an expense. The expenses in both cases failed for deduction because they were not disbursements or expenses wholly and exclusively laid out or expended for the purpose of the trade of the taxpayers. Both of these cases are United Kingdom cases. The statutory provisions in the United Kingdom are similar but not the same as ours. In those cases, the words falling for interpretation appear to have been ' any disbursements or expenses not being money wholly and exclusively laid out or expended for the purposes of such trade ...' . Since those words for interpretation are not in our sections 16 and 17, those decisions are not useful to us. The Respondent also urged upon us the findings in the Wharf case where it was held that in determining the deductibility of an expense, '*one should examine not only the status or nature of the expenditure but also the reason or purpose for which and the circumstances under which it was incurred*' . We observe that these findings were made in that case in determining whether an expense was of a capital or revenue nature for the purpose of section 17(1)(c) of the IRO. Although we are not concerned with section 17(1)(c), we would nonetheless bear in mind these findings in considering the deductibility of the expenses in the present case. The Respondent also submitted that for a loss to qualify for deduction, it had to satisfy the conditions that ' the risk was inherent, the loss was unavoidable and the trade must be systematically exercised' . It is apparent that these conditions were conclusions drawn by the Respondent from the following passages from the case of Sweetman v CIR, quoted to us by the Respondent in his submission:

> ' *(i) "The court acknowledged that theft of moneys by shop employees should, prima facie, be allowed as deductions on the footing that they are risks inherent in, or incidental to, the conduct of a business ..." (emphasis added)*
>
> *(ii) "There is no difficulty in understanding that involuntary outgoings and unforeseen and unavoidable losses should be allowed as deductions when they represent that kind of casualty, mischance or misfortune which is a natural or recognised incident of a particular trade or business of the profits of which are in question. These are characteristic incidents of the systematic exercise of a trade or the pursuit of a vocation." (emphasis added)*

(iii) *"The risk of misappropriation by a partner in a business or a profession is these days a natural incident of the carrying on of a business or profession and, in that respect, is not to be distinguished from the risk of theft by an employee in a business. That risk of loss is "inherent in the income-earning process of" a business or a professional practice, ..." (emphasis added)'*

These conditions for deductibility as suggested by the Respondent were not issues argued and determined under the Sweetman case but were only conclusions drawn by the Respondent from statements made therein. We find it unsafe to be bound by them, for the purpose of determining allowable deductions. If those conditions were indeed contemplated by the legislature as conditions to qualify an expense for deduction, we believe they would have been laid down as such under section 16 which provides the criteria for deductibility, or perhaps, as conditions to disqualify an expense for deduction under section 17 which provides exclusions.

71. Having expressed our views on the legal principles on deductibility of an expense in relation to those authorities, we now first turn to the item of investigation fee. By Company F' s letter to the Taxpayer and SEHK of 16 September 1997, it was a term of its engagement that fee notes would be issued every two weeks and should be payable by Company B upon presentation and that SEHK would not be liable under any circumstances for the fees and Company B agreed to waive its rights, if any, to claim against SEHK for such fees or any part thereof. By 8 January 1998, Company F issued the final report on their review. The Respondent did not dispute that it was incurred in the year of assessment in question. Thus, we find that the investigation fee was a disbursement expended by the Taxpayer in the year of assessment in question. As to the other criterion for permissibility of deduction under section 16(1), we hold the view that the fee was incurred in the course of the Taxpayer' s business for purpose of production of profits. To enable herself to continue her business as a securities dealer, the Taxpayer had to comply with the direction of SEHK and to carry out the investigation. As stated in the press release of SEHK, their first task was to establish the extent of the losses so as to ensure Company B having sufficient resources to meet its liabilities and the ability to continue trading and in full compliance o the applicable financial resources rules. One of the objectives of the engagement of Company F was to review the potential claims against the Taxpayer. Thus, in order that Company B could carry on business, the Taxpayer must appoint Company F to carry out the review. In other words, the expense was incurred in the course of carrying on the business of Company B with a view to continuing it the purpose of which must be for production of profits. While satisfying the two criteria under section 16(1), the investigation fee also does not fall within any of the exclusions under section 17(1). Consequently, we find that this item of expense qualifies as a deduction for the purpose of ascertaining the assessable profits of the Taxpayer in the year of assessment in question. Mismanagement of business and breaches of regulatory rules on the part of the Taxpayer should not affect the interpretation of sections 16 and 17 of the IRO which determine when an expense is an allowable deduction.

72. We now turn to the section item of expenditure claimed for deduction, the provision for exceptional loss. This item, unlike the other, was a provision only and it was not actually paid out in the year of assessment in question. On this question of whether a 'provision for payment' is a deductible expense, we derive assistance from the case of Lo & Lo v CIR. Their Lordships of the Privy Council held that '*in construing section 16, weight must be given to the fact that deductions are not confined to sums actually paid by the taxpayer*', '*"an expense incurred" is not confined to a disbursement and must at least include a sum which there is an obligation to pay, that is to say an accrued liability which is undischarged*', and '*a sum is an outgoing or expense incurred during a particular period only if that sum is paid or there is a legal or practical liability to pay it in that period*'. It follows from these legal principles that if the Taxpayer had an accrued liability whether legal or practical for payment of the exceptional loss in the year of assessment in question, the Taxpayer's provision for the exceptional loss would qualify as a deductible expense even though the exceptional loss was not actually paid out in the year of assessment in question.

73. In the case of Lo & Lo v CIR, the principal question in issue was '*whether the sum transferred to reserve as distinct from being paid out, was a proper deduction for the purpose of ascertaining the profits in respect of which the firm were chargeable to tax*'. This principal question also involved a subsidiary point, '*whether the sum actually claimed to be deducted, if otherwise allowable, should be disallowed because it was not an adequately measured appraisal of the liability.*' On the principal question, their Lordships of the Privy Council held that although the retirement benefit was not to be paid in the year of assessment but in future, the firm had no power to defer payment for any longer than the employee wished. The right of the employee to receive his retirement benefit was absolute and even the right of forfeiture in case of an employee's dismissal for dishonesty, serious misconduct or gross inefficiency would not make the right contingent. The right was a vested right defeasible only in one possible but unlikely event. The corollary of the view that the long service employee had a vested right to his accrued lump sum payment was that the firm had an accrued liability for that sum. On the subsidiary point, the Board of Review, the High Court and the Court of Appeal accepted that the sum carried to reserve was sufficiently accurate. Thus their Lordships considered that that conclusion was not open to a successful challenge.

74. Having carefully considered the facts of both cases whether they are mentioned herein or not, we find that the firm's liability in the Lo & Lo case is distinguishable from the liability of the Taxpayer in the present case. In the present case, the exceptional loss represented the total amount of the claims valued as at 11 August 1997 assessed by Company F. We find that the Taxpayer did not have an accrued liability, legal or practical, for payment of the exceptional loss in the year of assessment in question. We say that the Taxpayer did not have a legal liability for payment of the exceptional loss because as stated in Company F s report, the review did not cover the legal aspects relating to the claims and should not be solely relied on to determine the legal liabilities in respect of those claims. Thus, the Taxpayer did not have a legal liability for those claims as assessed

by Company F. Nor we find the Taxpayer admitted those claims or any part thereof as an accrued practical liability for payment. By referring us to fact (13) of the statement of facts prepared by the Commissioner, the Taxpayer' s tax representatives submitted that the claims of $3,252,117 and $5,061,734 were admitted by the Taxpayer during the year ended 31 March 1998. Fact (13) of the statement of facts reads as follows:

> ' In response to the assessor' s enquiry, the Representatives gave the following particulars in respect of the claims of [the District D branch] clients:
>
> (a) As at 31 March 1998, claims of $3,252,117 were admitted and were paid during the period from 1 April 1998 to 30 November 1998.
>
> (b) Further, claims of $5,061,734 were admitted but were not yet paid until 9 December 1998.
>
> (c) SEHK had since given approval for [Company B] to reduce its provision for claims to $28,800,000 (Appendix G).
>
> (d) Up to 31 March 1998, no claims had been rejected by [Company B].
>
> (e) No insurance, compensation, indemnity moneys had been received up to 30 November 1998.
>
> (f) No insurance moneys receivable had been confirmed up to 14 December 1998.'

We feel that we cannot rely on this passage as evidence to support that the tax representatives' claim that those claims of $3,252,117 and $5,061,734 were admitted during the year ended 31 March 1998. It is a fact, as stated at the beginning of the passage, that the particulars were supplied to the assessor in response to his enquiry, and this fact was acknowledged by the Commissioner in the statement of facts, but it does not follow that the Commissioner acknowledged that those particulars themselves were facts or that they were taken as proved. Those particulars were only allegation of facts which need to be substantiated by evidence. In the absence of proof, we are unable to accept that the Taxpayer had admitted the claims valued as at 12 August 1997 assessed by Company F or those claims of $3,252,117 and $5,061,734 and had incurred the liability for payment of the same during the year ended 31 March 1998. On the other hand, we have evidence from Mr M, the accounting manager of Company B that he gathered information from the claimants and verified those claims for the management' s approval. After approval, he then withdrew shares to settle the verified and approved claims. If the Taxpayer had admitted those claims as assessed by Company F, further verification and approval of those claims would not have been necessary. Also, as submitted by her tax representatives in paragraph 4.2 of their written submission of 2 March 2001, the Taxpayer ' was required to make good the losses if proven valid by the customers. No

payments were made in the year of assessment 1997/98 as it took time for the [Taxpayer] to process the claims.' The Taxpayer started purchasing replacing shares on 22 January 1998 but did not begin to settle those claims until 25 May 1998. Hence, on the basis of the evidence before us, we cannot accept that the Taxpayer had admitted any claims in the year of assessment in question. Thus, we find that the Taxpayer had neither an accrued legal nor practical liability for payment of the exceptional loss, whether it be $46,000,000 or $28,000,000 in the year of assessment in question. It follows that the provision for the exceptional loss does not qualify as an allowable expense for the year of assessment 1997/98.

75. Even if we were to find that the Taxpayer had an accrued liability for the payment of the exceptional loss in the year of assessment in question (which we do not), the Taxpayer's claim would still fail on the subsidiary question, because the exceptional loss could not be allowed for the reason that it was not an adequately measured appraisal of the liability. The provision for the exceptional loss was based on the value of the stock losses as at 12 August 1997. As shown in the report of Company F, a large proportion of the claims comprised the purchase of replacement stocks. That being the case, the Taxpayer's liability would be subject to stock price fluctuation. As reported by Company F, there were unsubstantiated claims which no doubt would also affect the Taxpayer's liability. Also the provision for loss had not taken into account the amount recoverable under the policy of insurance taken out by the Taxpayer. Hence the provision for exceptional loss whether it be $48,600,000 or $28,000,000, was not an adequately measured appraisal of the liability. Our view is further fortified by the fact that by its letter of 28 August 1998, Company B sought approval from SEHK to reduce its provision for exceptional loss from $48,600,000 to $10,000,000 because it took the view that the provision was substantively higher than reality. Furthermore, in their letter of 7 February 2001 to this Board, the Taxpayer's tax representatives said that with the benefit of hindsight, they would consider the loss incurred by the Taxpayer for the year of assessment 1997/98 to be $14,296,827. Thus, the exceptional loss whether it be $46,000,000 or $28,000,000 would also fail as an allowable expense for the reason that it was not an adequately measured appraisal of the liability.

76. Had the exceptional loss been incurred, we would find that it was incurred in the course of Company B's business for the production of assessable profits for the same reason as we have found in respect of the investigation fee.

77. Since the provision for exceptional loss does not qualify for deduction under section 16(1), we need not concern ourselves with section 17. Had it been necessary for us to do so, we would say that the provision of section 17(1)(e) should apply and the exceptional loss should be reduced by such amount as recoverable under the policy of insurance.

78. For the aforesaid reasons, the Taxpayer's appeal is allowed in relation to the investigation fee of $2,400,000 and is disallowed in relation to the provision for exceptional loss.

79. The Taxpayer' s tax representatives submitted to the Board that if the appeal failed, the amount of $5,114,462 and any future amount payable in settlement of claims should be allowed as deductions in ascertaining the Taxpayer' s profits for the period ended 6 May 1999, the date of cessation of business, under section 15D(2) of the IRO. Since the assessment under appeal is in relation to the year of assessment 1997/98, we have no jurisdiction over the Taxpayer' s tax liabilities of other assessment years and thus we are unable and will not make a ruling thereon.

80. We also record that in the course of the parties' submissions under this appeal, there were disputes on the admissibility of certain evidence given by Mr N, an expert witness for and on behalf of the Taxpayer. The Respondent submitted that the evidence given by Mr N in relation to the Taxpayer' s internal control was general information only and as to the transactions carried out by Mr E which produced commission and brokerage income for Company B was hearsay and as such, those aspects of the evidence should not be admitted. In reaching our decision on the deductibility of the exceptional loss and the investigation fee, we need not and did not take into account such part of the evidence of Mr N as disputed by the Respondent. Consequently, we see no necessity for us to consider and to make a ruling on the admissibility of such part of the evidence of Mr N disputed by the Respondent as aforesaid.

81. The Taxpayer' s tax representatives made and sent a second written submission to the Board on 12 April 2001 in response to the Commissioner' s written reply dated 4 April 2001. Since the hearing of the appeal was concluded on 6 April 2001 upon presentation of the parties' respective written submissions, the Board did not see fit that it should accept further written submissions from either party to the proceedings after that date.

82. Finally, we would put on record that Mr N' s professionalism or competence was in no way undermined in the course of this appeal.