

Case No. D14/12

Profits tax – artificial or fictitious transactions – deductibility of expenses – sections 16, 17, 22, 61 and 65(7) of the Inland Revenue Ordinance ('IRO').

Panel: Horace Wong Yuk Lun SC (chairman), Lo Pui Yin and Wong Ho Ming Horace.

Dates of hearing: 25 June and 2 July 2009.

Date of decision: 9 July 2012.

The Taxpayer was and is a firm of solicitors of which Mr A was a partner. The Taxpayer claimed that it had paid management fees to Company B/Company D pursuant to the service agreements between them, and its profits tax should be assessed on this basis.

The Deputy Commissioner, however, determined that: (a) The entering into of service agreements between the Taxpayer and Company B/Company D, the carrying out of the service agreements and the charging of management fees to Company B/Company D by the Taxpayer in computing its assessable profits were artificial and fictitious transactions within the ambit of section 61 of the IRO.

The Deputy Commissioner also rejected the Taxpayer's claim that the medical expenses of the Taxpayer and the insurance expenses in respect of the insurance premium paid for the third party liability insurance policy for Mr A's car were deductible expenses for the purposes of sections 16 and 17 of the IRO.

Held:

1. A four-stage process was involved in the application of section 61 of the IRO to transactions: (a) Identify/define the transaction; (b) Consider whether the transaction reduces or would reduce the amount of tax payable by any person; (c) If it does, consider whether the transaction is artificial or fictitious; and (d) If it is, the transaction may be disregarded and the person concerned shall be assessable accordingly (D13/07, (2007-08) IRBRD, vol 22, 365).
2. The transactions for the purpose of the determination of the application of section 61 in the appeal are: (a) the entering into of the agreements between the Taxpayer and Company B/Company D; (b) the carrying out of the agreements; and (c) the alleged payment of management fees by the Taxpayer to Company B/Company D.

3. Whether a transaction is commercially unrealistic can be one of the considerations for deciding whether the transaction is 'artificial'. Whether a transaction which is commercially unrealistic must necessarily be regarded as being 'artificial' depends on the circumstances of each particular case. (Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773 at paragraph 41; Seramco Trustees v Income Tax Commissioners [1977] AC 287 at 298A-D).
4. In relation to Company B, each and every of the relevant transactions in the years of assessment in question said to be associated with the management services arrangements the Taxpayer had had with Company B was commercially unrealistic and artificial. None of the factors submitted on behalf of the Taxpayer as supporting its setting the range and fixing the actual amount of management fees in a commercially realistic manner has been established. The additional features, identified in paragraph 40 of this Decision, also point to the artificiality of the transactions in question in the ordinary sense of that expression.
5. In relation to Company D, the Taxpayer has shown that the amount of management fees it received from the Taxpayer did bear a correlation with the services Company D provided. The arrangements between the Taxpayer and Company D did have a sense of commerciality, and were not artificial or fictitious. Accordingly, it was not correct for the Deputy Commissioner to apply section 61 of the IRO to disregard the transactions involving Company D and assess the Taxpayer's profits tax liability without allowing the deduction of the management fees recorded as paid to Company D. The management fees recorded as paid to Company D were deductible expenses for each and every of the years of assessment in question.

Medical Expenses

6. Sections 16 and 17(1)(b) of the IRO together show that a deductible expense must be money expended for the purpose of production of profits. Reference was also made to Strong & Co v Woodfield [1906] AC 448, HL at 452 (per Lord Loreburn) and 453 (per Lord Davey) and Commissioner of Inland Revenue v Chu Fung Chee [2006] 2 HKLRD 718, CFI at [18] to [21] (where Chung J reviewed the authorities).
7. Medical expenses are of a private nature and thus not deductible (Anthony Patrick Fahy (t/a A P Fahy & Co) v Commissioner of Inland Revenue [1992] 1 HKLR 207 at 208 to 209).
8. The Board rejected the Taxpayer's claim of medical expenses as a deductible expense due to the Taxpayer's failure to provide sufficient supporting particulars of this claim. The Board also rejected the Taxpayer's submission

that the medical expenses claimed were a work benefit or akin to a work benefit applying Fahy (above).

Insurance Expenses

9. The Board rejected the Taxpayer's claim that the payment of premium for third party insurance of Mr A's car for 2000/01 should be a deductible expense. Costs of travelling associated with trips from residence to the place of business, and vice versa, are domestic or private expenses and not deductible: section 17(1)(a)(i) of the IRO. No part of the insurance premium should be allowed as a deductible expense because Mr A would have had to purchase third party insurance for the use of his motor vehicle for private purposes, including the travelling from home to work, as well as in the evenings and at weekends.

Appeal allowed in part.

Cases referred to:

D13/07, (2007-08) IRBRD, vol 22, 365
Seramco Trustees v Income Tax Commissioners [1977] AC 287
Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773
Strong & Co v Woodfield [1906] AC 448
Commissioner of Inland Revenue v Chu Fung Chee [2006] 2 HKLRD 718
Anthony Patrick Fahy (t/a A P Fahy & Co) v Commissioner of Inland Revenue [1992] 1 HKLR 207

Adrian Lai Counsel for the Taxpayer.

Yvonne Cheng Counsel instructed by Cecilia Siu, Acting Senior Government Counsel of the Department of Justice for the Commissioner of Inland Revenue.

Decision:

Introduction

1. The Taxpayer was and is a firm of solicitors. At all material times, Mr A was a partner of the Taxpayer.
2. The Taxpayer submitted profits tax returns for the years of assessment 1996/97 to 2001/02 stating an adjusted loss for each of these years of assessment.

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3. The Revenue raised profits tax assessments of the Taxpayer for each of the years of assessment 1996/97 to 2001/02, stating that there were assessable profits for each of these years after adding back to the relevant calculations salaries to partner, non-deductible expenses and management fees (where appropriate for the particular year of assessment).
4. The Taxpayer objected to the profits tax assessments for the years of assessment 1996/97 to 2001/02 on the ground that they were excessive.
5. The Revenue made enquiries of the Taxpayer, which provided information on three companies to which the Taxpayer had paid management fees as charged in its accounts in the years of assessment 1996/97 to 2001/02, namely Company B, Company C and Company D; and information on the medical expenses of the Taxpayer.
6. By a determination dated 24 December 2008, the Deputy Commissioner of Inland Revenue made a determination revising that the assessable profits for the years of assessment 1996/97, 1997/98, 1999/2000, 2000/01 and 2001/02 be increased and that the assessable profits for the year of assessment 1998/99 be reduced. The Deputy Commissioner determined that: (a) The entering into of service agreements between the Taxpayer and Company B, the carrying out of the service agreements and the charging of management fees to Company B by the Taxpayer in computing its assessable profits were artificial and fictitious transactions within the ambit of section 61 of the Inland Revenue Ordinance (Chapter 112); (b) The Taxpayer had not incurred any management fee payable to Company C for the year of assessment 1996/97; and (c) The entering into of service agreements between the Taxpayer and Company D, the carrying out of the service agreements and the charging of management fees to Company D by the Taxpayer in computing its assessable profits were artificial and fictitious transactions within the ambit of section 61 of the Inland Revenue Ordinance.
7. By a Notice of Appeal dated 22 January 2009, the Taxpayer lodged the present appeal with the Clerk to the Board of Review.

Statement of agreed facts

8. The legal representatives of the parties (the team led by Mr Adrian Lai for the Taxpayer and the team led by Ms Yvonne Cheng for the Revenue) have agreed on a Statement of Agreed Facts. This Statement of Agreed Facts (Annex A) is annexed to this Decision.

Grounds of appeal

9. The Taxpayer lodged on or about 22 January 2009 the first set of grounds of appeal contending, essentially, that the Deputy Commissioner erred in his interpretation and application of section 61 of the Inland Revenue Ordinance in his determination and should not have held that the service agreements between the Taxpayer and the three companies were shams.

10. In June 2009, the Taxpayer informed the Clerk to the Board of Review that it would rely on two additional sets of grounds of appeal, pertaining to three other expenses not deducted by the Revenue, namely, medical expenses, the salaries of Mr E, and insurance expenses. A document entitled 'Additional Grounds of Appeal' consolidating these grounds of appeal was placed before this Board of Review on 25 June 2009 by Mr Lai for the Taxpayer without objection from the Revenue.

Issues in the appeal

11. Ms Cheng for the Revenue had fairly and helpfully indicated that the Revenue would not seek to uphold in this Appeal the disallowance of the salaries of Mr E and the disallowance of insurance expenses (with the exception of the insurance premium paid for the third party liability insurance policy for Mr A's car).

12. Mr Lai for the Taxpayer also confirmed that the Taxpayer would not maintain its claim of \$50,000 as payment of management fee to Company C in the nature of an expense in the year of assessment 1996/97.

13. Hence the contentious issues between the parties in this Appeal are:

- (1) Whether the Deputy Commissioner was correct in exercising the power under section 61 of the Inland Revenue Ordinance to disregard the transaction between the Taxpayer and the two companies (that is Company B and Company D) with respect to management fees;
- (2) Whether the medical expenses of the Taxpayer were deductible expenses for the purposes of sections 16 and 17 of the Inland Revenue Ordinance; and
- (3) Whether the insurance expenses in respect of the insurance premium paid for the third party liability insurance policy for Mr A's car was a deductible expense for the purposes of sections 16 and 17 of the Inland Revenue Ordinance.

The Taxpayer's evidence

14. Apart from referring this Board to the documentary evidence placed before it, the Taxpayer called Ms F, its managing partner to give evidence. She confirmed her witness statement and agreed that the witness statement would stand as her evidence-in-chief. She was cross-examined.

15. Ms F is the wife of Mr A. She had been working in the Taxpayer as manager since its commencement in 1989 and joined the Taxpayer as partner in 1999.

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16. With respect to the aspect of management fees paid by the Taxpayer to the two companies, Ms F indicated in her evidence that Company B had held the tenancy of the offices from which the Taxpayer carried on its legal services business as a tenant of Company B in 1989 and the early 1990s. Later, office premises, namely Office A, Office D and Office B, were acquired by purchase by Company B, whose directors and shareholders had at all material times been Mr A and his brother Mr G. Company B also took the tenancy of Office E.

17. Ms F indicated in her evidence that Company D acquired by purchase the Godown and Office C. The directors and shareholders of Company D had at all material times been Mr A and Ms F.

18. Ms F indicated in her evidence that Mr A decided that, as the Taxpayer's business developed, office premises should be acquired, rather than rented, for investment purpose and for the possibility of future development of the Appellant's business. Mr A also decided that it should be Company B and Company D, rather than the Taxpayer, which should acquire the office premises, upon considering that the Appellant should focus on the provision of legal services and should keep away from property investment activities; that landed property should not be exposed to the creditors of the Appellant, operating a business of unlimited liability; that property acquisition and disposal should be within the Mr A family; and that at the relevant time, the business profits of the Appellant were not sufficient to support applications for mortgage loans.

19. Ms F indicated in her evidence that since 1994, the Taxpayer decided to rent offices from Company B and Company D; that the Taxpayer had received consultancy services from/through Company B and translation services from Company D; and that properties owned by Company B and Company D were pledged to banks for general banking facilities that the Taxpayer made use of frequently (as, it seemed from the bank statements of the Taxpayer, that the Taxpayer's cash position at all times was far from sufficient to meet its financial obligations), incurring interest expenses borne by Company B and Company D. Management agreements, found in Appendices E1-E6 referred to in the Statement of Agreed Facts in the case of Company B and in Appendices G1-G6 referred to in the Statement of Agreed Facts in the case of Company D, were entered between the Taxpayer and Company B and Company D (where appropriate) for the provision of the offices and godown, consultancy services, translation services and the payment of banking charges and interest expenses incurred by the Taxpayer using the banking facilities granted to Company B and Company D. According to Ms F, the consultancy services that Company B provided were concerned with the promotion of the image and business of the Taxpayer.

20. Ms F indicated in her evidence that regarding the management fees, based on the information that Mr A told her, Mr A would decide firstly on the range of the management fees and then decide on the actual fee after making adjustment(s). She did not know whether Mr A had the actual market rental in mind when setting range of the management fees, though she suggested that he did his own valuation. In addition, she

indicated that Mr A did not set a management fee range according to how much office space had been provided. Rather he took into account the number of offices the Taxpayer was using, the expansion plan of the Taxpayer and the economic factor, with a view to allowing a sufficient buffer.

21. Ms F was cross-examined with respect to the breakdown of management fees provided by the Taxpayer's Tax Representative, Company H, and it was pointed out to her that the breakdown had not included a column of banking facilities. Ms F's response was that although the Company H letter was countersigned by Mr A, the breakdown had escaped her attention.

22. Ms F lastly indicated in re-examination that some of the monies paid by the Taxpayer to Company B represented repayments for 'loans' provided by Company B to the Taxpayer. These repayments were more in the nature of expenses paid by Company B for the Taxpayer.

23. Turning to the aspect of medical expenses sought by the Taxpayer as an allowable deduction, Ms F gave evidence that the medical expenses were incurred for Mr A, Mr E and employees of the Taxpayer. She said that it was the policy of the Taxpayer to reimburse medical expenses, which only involved visits to clinics. She considered that they were incurred in the production of the Taxpayer's profits and should be allowed for deduction.

24. Ms F gave evidence that the motor vehicle (vehicle registration mark concealed) was used as the Taxpayer and Mr A ran a number of branches, and it was necessary for Mr A to attend court from time to time in the course of the Taxpayer's legal business. Upon cross-examination, Ms F accepted that she used the motor vehicle, that Mr A did not usually drive to work but preferred driving when going to court, and that the motor vehicle was put to private use at weekends.

The Revenue's evidence

25. The Revenue did not call any oral evidence. Reference was made by the Revenue in cross-examination and the submissions to the documentary evidence placed before this Board of Review.

The two companies' management fees: section 61, Inland Revenue Ordinance

26. Section 61 of the Inland Revenue Ordinance provides:

'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 assessed accordingly.'

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27. Mr Lai for the Taxpayer and Ms Cheng for the Revenue both made reference to D13/07, (2007-08) IRBRD, vol 22, 365 as to the steps to be taken in the application of section 61 of the Inland Revenue Ordinance. This appeal was also a case involving a solicitor's firm and a service Company. In paragraph 113, the Board of Review, having considered the authorities, indicated that a four-stage process was involved in the application of section 61 to transactions: (a) Identify/define the transaction; (b) Consider whether the transaction reduces or would reduce the amount of tax payable by any person; (c) If it does, consider whether the transaction is artificial or fictitious; and (d) If it is, the transaction may be disregarded and the person concerned shall be assessable accordingly.

28. There was essentially no difference between the parties as to the transactions involved in the context of this appeal, following paragraph 115 of the Board of Review's decision in D13/07 (above). The transactions for the purpose of the determination of the application of section 61 in this Appeal are: (a) The entering into of the agreements between the Taxpayer and Company B/Company D; (b) The carrying out of the agreements; and (c) The alleged payment of management fees by the Taxpayer to Company B/Company D.

29. These transactions did reduce the amount of tax payable by the Taxpayer because, as the Taxpayer's profit and loss accounts reproduced in paragraph 1(4)(a) of the Statement of Agreed Facts show, the payment of the management fees pursuant to the agreements between the Taxpayer and Company B/Company D were booked as deductions. The deductions of the management fees as an expense reduced the amounts of assessable profits of the Taxpayer and as a consequence reduced the amount of tax which would otherwise have been payable by the Taxpayer.

30. The disputed issue between the parties is whether these transactions were artificial or fictitious within the meaning of section 61 of the Inland Revenue Ordinance. The starting point in the deliberation of this dispute is to ascertain the applicable meaning of 'artificial' and 'fictitious' for the purpose of section 61. Here, in Seramco Trustees v Income Tax Commissioners [1977] AC 287, PC, Lord Diplock had these to say:

“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. Their Lordships will accordingly limit themselves to an examination of the share 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. 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 Lordship’s view a word of wider import’ (at 298A-D).

31. In Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773, the Court of Appeal, after considering the passage in Seramco Trustees (above), indicated that whether a transaction is commercially unrealistic can be one of the considerations for deciding whether the transaction is ‘artificial’. Whether a transaction which is commercially unrealistic must necessarily be regarded as being ‘artificial’ depends on the circumstances of each particular case (paragraph 41).

32. This Board has considered the circumstances with respect to Company B and with respect to Company D separately. This Board also accepts the submission of Mr Lai for the Taxpayer that each of the management agreements was a separate transaction and ought to be considered separately with respect to the relevant year of assessment and having no bearing on the Taxpayer’s tax liability in other years. On the other hand, this Board notes that Mr Lai accepted that the circumstances giving rise to the management agreements ‘were largely the same, subject to some special circumstances’, which related to the management fee arrangements for the years of assessment 1998/99 and 1999/2000.

33. This Board has heard and observed the testimony of Ms F. This Board finds Ms F to be an unreliable witness. While Ms F has claimed to have been the manager of the Taxpayer from the commencement of the legal service business, she has only been able to assert general and broad assertions in her evidence and failed to explain many of the specific matters put to her in cross-examination. It may be that the relevant decisions were made by Mr A and Ms F was not privy to his thinking. But some of those matters are supposed to be naturally within Ms F’s knowledge and her failure or inability to explain plainly has not assisted the Taxpayer’s case. In such circumstances, it is inevitable, in this Board’s view, that the Taxpayer would fail in coming to prove on the balance of probabilities the related assertion(s) it has sought to substantiate through Ms F’s evidence.

Company B

34. Company B was at all material times owned by Mr A and his brother Mr G; they were the only directors and shareholders of Company B. The registered office of Company B was at Office A, one of the offices of the Taxpayer.

35. Company B had mainly two sources of income: management fees from the Taxpayer and rental income earned from letting out premises. However, it is noted that with the exception of the year of assessment 1996/97, where rental income was 21 per cent of the total income of Company B, rental income had throughout all material times been less than 6 per cent of the total income of Company B (see Statement of Agreed Facts, paragraph 1(9)(h)).

36. In support of its case that the management service arrangements with Company B were commercially realistic, the Taxpayer submitted that the management fees it paid to Company B were fixed by reference to the rental the Taxpayer ought to pay for the office premises of Company B it occupied, interest expenses incurred by the Taxpayer’s use

of banking facilities obtained by Company B, consultancy services provided by Company B and the sustainability of the Taxpayer and Company B.

37. This Board is satisfied that the management fees, be it set in a range annually or as paid, cannot support the Taxpayer's case that the management service arrangements between the Taxpayer and Company B were commercially realistic. As Ms Cheng had demonstrated on behalf of the Revenue, the alleged 'rental' factor supposed to be in the management fees set and paid year by year bore no semblance of a relation with the market rentals assessed by the Commissioner of Rating and Valuation (the accuracy of which was not challenged by the Taxpayer). The management fees set and paid each year also had no tangible relationship with the amount of office space to be provided under the management agreements. It was suggested on behalf of the Taxpayer that the market rentals assessed by the Commissioner of Rating and Valuation were not comparables. But, as Ms Cheng had demonstrated by reference to the breakdown of the management fee supplied by Company H on behalf of the Taxpayer, that even if one adds to the Commissioner of Rating and Valuation's market rentals the building management fee, the Government rent and the rates, the rentals asserted in the Company H breakdown were several times more than the Commissioner's market rentals so adjusted. While the market rentals assessed by the Commissioner of Rating and Valuation were on an unfurnished and unequipped basis, Ms Cheng had again shown that the Company H breakdown likewise did not take equipment into account; and that the equipment rental element in that breakdown, when contrasted with Company B's accounts on the acquisition of equipment, furniture and decoration over the entire six year period in question, was plainly uncommercial. It was suggested on behalf of the Taxpayer that this Board should prefer Ms F's evidence to the Company H breakdown, which Ms F, it was said, had not considered and which was not supported by any evidence. Having reviewed the Company H breakdown, this Board disagreed with this suggestion. It cannot simply be said that the Company H breakdown was unsupported by evidence when the whole document was stated to be prepared as a reply to the Revenue's request for information of Company B and reviewed and approved by the Taxpayer. There was annexed to the document three appendices of accounting printout of Company B showing three heads of expenses. Thus this Board considers that Ms Cheng was entitled to regard the Company H breakdown as an assertion, with the approval of the Taxpayer, of how the management fee for the year of assessment 2001/02 was regarded as representative of the various elements or factors that contributed to the fixing of the management fee with Company B by the Taxpayer, and to draw this to the attention of this Board, notwithstanding Ms F's evidence.

38. The Taxpayer also relied on the 'interest expenses' factor relating to the asserted use by the Taxpayer of banking facilities Company B obtained by mortgaging the properties it owned. The Revenue challenged the inclusion of this factor, suggesting that this was a 'recent fabrication', pointing to the fact that the management agreements themselves do not mention the use of banking facilities; the fact that correspondence the Taxpayer had with the Revenue had not mentioned the provision of banking facilities was one of the services Company B provided to the Taxpayer; and the evidence that Ms F gave mutually inconsistent answers under cross-examination on why the Taxpayer's letter dated

22 October 2008 to the Revenue did not mention that the adjustment of the management fees for Company B depended on interest expenses. This Board agrees that the Revenue has shown that there is an objective evidential basis undermining the credibility of the claim that the management fees included an ‘interest expenses’ factor. Moreover, an examination of the flow of funds between the Taxpayer and Company B fails to find support of the Taxpayer’s claim that it used the banking facilities of Company B on a constant basis throughout the years of assessment in question. Rather it seems that there was a steady flow of substantial or not insubstantial revenue from the operations of the Taxpayer and that such revenue of the Taxpayer (and its profits) were paid out to Company B in the main or others soon after the said funds were deposited. Ms F confirmed that was the *modus operandi* of the Taxpayer in the years of assessment under cross-examination. Although Mr Lai for the Taxpayer criticized the Revenue’s analysis of the evidence for wrongly relying on the financial statements of the Taxpayer (which were prepared on the accrued basis and not the cash basis), the Revenue’s analysis of the bank slips and bank statements (which Mr Lai accepted to be evidence in the correct context), which this Board agrees, does show that the claimed ‘cash shortage’ of the Taxpayer was more likely than not to have been self-induced by the Taxpayer, which had paid out its earnings to Company B soon after it received them, so that in effect the funds of the Taxpayer were being held by Company B. The Taxpayer’s claim that it had to use the banking facilities obtained by Company B for the maintenance of its daily operations (and the ‘vitality’ of its business) and did use such banking facilities for such purpose, so as to incur interest charges that it had to repay Company B, has not been substantiated on a balance of probabilities. The fact of Company B incurring interest expenses, which the Taxpayer has suggested would have been much less had the Taxpayer not made use of the banking facilities of Company B, was capable of other reasonable explanations, such as in furtherance of Mr A’s plan to expand the family property investment portfolio. Further, there was a dearth of evidence condescending to particulars before this Board as to how ‘interest expenses’ featured as a factor in the fixing of the range of management fees throughout the years of assessment by Mr A of the Taxpayer with Company B. Accordingly, this Board is not satisfied that the claimed ‘interest expenses’ legitimately contributed to, or in any event, played a significant part in shaping the commercial realism of the management service arrangements between the Taxpayer and Company B.

39. Next, the Taxpayer claimed that Company B provided ‘consultancy services’ to the Taxpayer. The elaboration of what were the consultancy services provided came for the first time in the examination-in-chief of Ms F. They were marketing consulting undertaken by Mr G, who himself did not receive a dollar for such services rendered. There was no evidence of how much the consultancy services were valued or estimated in monetary value. This Board is of the view that the Taxpayer has plainly failed to establish that ‘consultancy services’ were a factor involved in the management arrangements between the Taxpayer and Company B.

40. The last factor that the Taxpayer claimed to be involved in the setting of the range and the fixing of the actual payment of management fees was the ‘sustainability’ and ‘survival’ of the Taxpayer and Company B. The special circumstances that Mr Lai has

identified in his closing submission, namely the actual payment of management fee \$1.46 million in 1998/99 and the mutual agreement between the Taxpayer and Company B to reduce the management fee range, are said to be reflective of how the two sides reacted to changing business circumstances. Ms Cheng submitted in response that these matters, particularly the latter one, 'only serves to underline that the "fees" bore no relationship to the level of services which were allegedly to be provided in the period covered by the agreement. On the contrary: they were adjusted because of factors relating to [the Taxpayer] in the past.' This Board agrees with this submission. Further, Ms Cheng argued that the survival of Company B in the way it had been run was simply the choice of its directors and shareholders, since the banks were secured in respect of the banking facilities separately by the mortgage over the properties and Mr A's personal guarantee. This Board also agrees with the submission.

41. While the main area of contentions between the parties on whether the management services arrangements with Company B were artificial transactions has been the commercial reality of the setting and the actual payments of the management fees, this Board has also been drawn to other matters that might assist in determining the nature of the transactions. Some of these matters are discussed below:

The business practice of setting a 'range' of the management fees payable:

This Board finds no evidence of this business practice, no guidance established between the Taxpayer and Company B as to the policy and process over the setting of the 'range', and no provision as to how the final fee was to be determined bearing in mind the wide range of the fees said to have been set.

The retrospective fixing of the management fees to be paid:

This Board considers that the rationale put forward for retrospective fixing from the set 'range', namely adjustment according to the Taxpayer's turnover, does not make sense where the management fee is said to be payment for services rendered by Company B. The apparent freedom with which Mr A fixed the management fees actually paid retrospectively, bearing particularly in mind that the payment in 1998/99 of \$1.46 million was in sharp departure of the set range of \$2 million to \$3 million, did not sit well with the Taxpayer's assertion of arm's length dealing between itself and Company B.

The management fees having been fixed arbitrarily:

The Taxpayer submits that the actual paid amount was fixed by Mr A having balanced the interests of the Taxpayer and Company B. The Revenue submits that there was no breakdown of the actual fees and it would be obvious to infer that no rational breakdown could have been provided. However, this Board does not consider that this inference necessarily follows from the mere absence

of a breakdown, bearing in mind that it can be difficult to express in concrete terms a balancing exercise.

Whether the management agreements were contemporaneous:

This Board agrees with the Revenue's submission that it cannot take the management agreements at face value, not least because it is more likely than not that the management agreements were not signed on the dates on which they purported to have been signed.

The Taxpayer occupied and used Office E without making any agreement with Company B:

Ms F could not explain how it came about that the Taxpayer could and did use Office E without the making of any agreement with Company B.

Flexibility of related companies:

While management agreements between the Taxpayer and Company B have been put forward as part of the case of the commercial realism of the transactions, namely dealing at arm's length, Ms F's response under cross-examination with respect to examples illustrating the absence of need for any agreement was that these two related companies exercised 'flexibility' in their arrangements. This Board recognizes the force of this point in highlighting the artificiality of the management services arrangements.

'Payment' patterns:

There was no payment of the management fees recorded on the accounts, whether in one payment or a number of periodical payments. There were instead frequent and irregular transfers of irregular amounts from the Taxpayer's account to Company B's account. Payments over and above the Taxpayer's obligation to pay management fees said to be actually fixed by Mr A were not paid back to the Taxpayer; this was confirmed by Ms F. There was no explanation from Ms F for this way of doing things. Ms Cheng for the Revenue invited this Board to find that the payment patterns and amounts have shown that transfer of funds to Company B were not made because of services rendered by Company B but rather they were payments because of receipts of income by the Taxpayer; and that they were not payments of management fee but drawings by the Taxpayer's proprietor from his business. This Board does make these two findings.

42. On the basis of the above discussion, this Board decides that each and every of the six sets of transactions in the years of assessment in question said to be associated with the management services arrangements the Taxpayer had had with Company B was

commercially unrealistic and artificial. None of the four factors submitted on behalf of the Taxpayer as supporting its setting the range and fixing the actual amount of management fees in a commercially realistic manner has been established. This Board further accepts that there are additional features, identified in the preceding paragraph, that point to the artificiality of the transactions in question in the ordinary sense of that expression.

Company D

43. The Taxpayer, through Ms F, has asserted that the management service arrangements with Company D were to cover the rental of Office C and the Godown, the provision of bank facilities and translation service.

44. Ms F, in her testimony, accepted that the translation service actually provided on behalf of Company D to the Taxpayer was in a 'very limited amount'.

45. Mr Lai on behalf of the Taxpayer placed emphasis on the fact that the actual amount of the management fees paid by the Taxpayer to Company D were close to the open market rental values estimated by the Commissioner of Rating and Valuation.

46. Ms Cheng submitted on behalf of the Revenue that many of the considerations applicable to the management service arrangements between the Taxpayer and Company B apply to the management service arrangements between the Taxpayer and Company D.

47. In the light of the discussion earlier in this Decision, Ms Cheng's submission has some force. However, this Board has to have regard to the consideration that even after having discounted the rationales for the use of banking facilities and provision of translation service, the predominant consideration for fixing the management fees actually paid to Company D would have been enjoyment and use by the Taxpayer of the premises held by Company D.

48. This Board is satisfied that the Taxpayer has shown that in relation to Company D, the amount of management fees it received from the Taxpayer did bear a correlation with the services Company D provided. This Board is satisfied that the arrangements between the Taxpayer and Company D did have a sense of commerciality, and were not artificial or fictitious. Accordingly, it was not correct for the Deputy Commissioner to apply section 61 of the Inland Revenue Ordinance to disregard the transactions involving Company D and assess the Taxpayer's profits tax liability without allowing the deduction of the management fees recorded as paid to Company D. This Board holds that the management fees recorded as paid to Company D to be deductible expenses for each and every of the years of assessment in question.

Medical expenses: sections 16, 17, Inland Revenue Ordinance

49. Section 16(1) of the Inland Revenue Ordinance provides:

‘ 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 ...’.

50. Section 17(1) of the Inland Revenue Ordinance provides:

‘ 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-

(a) domestic or private expenses, including-

(i) the cost of travelling between the person’s residence and place of business; ...

(b) subject to section 16AA, any disbursements or expenses not being money expended for the purpose of producing such profits ...’

51. It is clear to this Board that sections 16 and 17(1)(b) of the Inland Revenue Ordinance together show that a deductible expense must be money expended for the purpose of production of profits. See also Strong & Co v Woodfield [1906] AC 448, HL at 452 (per Lord Loreburn) and 453 (per Lord Davey) and Commissioner of Inland Revenue v Chu Fung Chee [2006] 2 HKLRD 718, CFI at [18] to [21] (where Chung J reviewed the authorities).

52. Section 17(1)(a) of the Inland Revenue Ordinance expressly and specifically provides that domestic and private expenses are not deductible.

53. Medical expenses are of a private nature and thus not deductible; see Anthony Patrick Fahy (t/a A P Fahy & Co) v Commissioner of Inland Revenue [1992] 1 HKLR 207 at 208 to 209.

54. The Taxpayer claimed that the medical expenses, consisting of reimbursement of out-patient medical claims by those working with the Taxpayer and miscellaneous first-aid items purchased from dispensaries, ought to be deductible. In particular, Mr Lai submitted on behalf of the Taxpayer that Fahy (above) was not applicable since reimbursing the out-patient medical claims was ‘more likely a work benefit’ for the employees and other persons working for the Taxpayer.

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55. The Revenue opposed this claim on three bases. Firstly it was submitted that the Taxpayer had not produced proper evidence to show that medical expenses were incurred and what they were. Secondly the expenses were non-deductible, being private in nature. Thirdly, the Taxpayer was assessed as a firm and so assessment was made of the partners jointly; see section 22 of the Inland Revenue Ordinance. The partners may not claim deduction of medical expenses. The Taxpayer had not provided any breakdown to show which expenses claimed were incurred in respect of employees and which were in respect of Mr A and Ms F, the partners. Thus there cannot be any claim for expenses in respect of the employees.

56. This Board rejects the Taxpayer's claim of medical expenses as a deductible expense. The Taxpayer has simply failed to make good its claim for expenses in respect of the employees. The records shown to this Board, which constituted the only set of supporting particulars of this claim, show only the item of expense and the sum of money involved with no information on the person to whom the item of expense was associated. Further, this Board rejects the Taxpayer's submission that the medical expenses claimed were a work benefit or akin to a work benefit. Rather, this Board applies Fahy (above) and holds the medical expenses to be not deductible.

Insurance

57. The item of insurance disputed between the parties is the payment of premium for third party insurance of Mr A's car for 2000/01.

58. Ms F stated in her evidence that Mr A used the car to travel between offices and between offices and courts. Therefore it was submitted on behalf of the Taxpayer that the insurance premium paid by the Taxpayer was for the production of the Taxpayer's income.

59. Ms F also stated in her evidence that Mr A used the car for private purposes, such as trips in the evenings and on weekends.

60. This Board rejects the Taxpayer's claim that the payment of premium for third party insurance of Mr A's car for 2000/01 should be a deductible expense. Costs of travelling associated with trips from residence to the place of business, and vice versa, are domestic or private expenses and not deductible: Inland Revenue Ordinance, section 17(1)(a)(i). The Board considers that no part of the insurance premium should be allowed as a deductible expense. This is because Mr A would have had to purchase third party insurance for the use of his motor vehicle for private purposes, including the travelling from home to work, as well as in the evenings and at weekends.

Conclusions and disposition

61. By reason of the aforesaid, this appeal is allowed in part. The following deductions are allowed:

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- (1) Mr E's salaries of \$30,000 (in 1997/98)
- (2) Insurance expenses of \$95,297 (in 2000/01) which in turn comprise premia for compulsory professional insurance of \$93,512 and employees' compensation insurance of \$1,785
- (3) Management fees recorded as paid to Company D, namely \$100,000 (in 1996/97), \$140,000 (in 1997/98), \$100,000 (in 1998/99), \$150,000 (in 1999/2000), \$100,000 (in 2000/01) and \$100,000 (in 2001/02).

62. The Revenue shall revise the profits tax assessments of the Taxpayer for the years of assessment 1996/97, 1997/98, 1998/99, 1999/2000, 2000/01 and 2001/02 accordingly.

63. If the parties can come to an agreement on the calculations of the revised assessments, they should submit an agreed schedule of computations to the Clerk to the Board of Review for the record. If the parties cannot come to an agreement on the calculations of the revised assessments, they should make arrangements with the Clerk to the Board of Review for the matter to be determined by this Board.

64. This Board regrets that the making of this Decision has taken considerably much more time than one may have desired, not least that by the time a draft of this Decision was circulated, a member of this Board, Wong Ho-ming Horace, FCIS, had ceased to be a member of the panel of the Board of Review (Inland Revenue Ordinance). However, pursuant to section 65(7) of the Inland Revenue Ordinance, Mr Wong continues to determine this appeal. Therefore, this Decision represents the unanimous views of all members of this Board.

65. This Board thanks counsel of the parties for their helpful and co-operative assistance.

Annex A

[Editor's note: the appendices to Annex A are not published.]

Statement of Agreed Facts

- (1) [The Taxpayer] ('the Firm') has objected to the Profits Tax assessments for the years of assessment 1996/97 to 2001/02 raised on it. The Firm claims that in computing its assessable profits, the management fee expenses should be allowed in full.
- (2) The Firm has carried on a legal service business since 15 June 1989. It made up its accounts to 31 March annually. At the relevant time, the Firm was run by the following persons:

	<u>Date joined</u>	<u>Date left</u>	<u>Profit sharing ratio</u>	
			<u>on and before 30 April 1999</u>	<u>on and after 1 May 1999</u>
Mr A	15-6-1989	-	100%	90%
Mr J ¹	26-2-1996	2-10-1999	-	-
Ms K ¹	18-5-1998	1-11-1999	-	-
Ms F ²	1-5-1999	-	-	10%

¹ Mr J and Ms K were salaried partners of the Firm.

² Mr A and Ms F ['the Wife'] are husband and wife.

- (3) During the years of assessment 1996/97 to 2001/02, the Firm maintained the following places of business:

<u>Period</u>	<u>Location</u>	
1-4-1996 to 31-3-2002	[Address concealed]	['Office A']
1-7-1996 to 23-11-1999	[Address concealed]	['Office B']
15-2-1997 to 14-6-2004	[Address concealed]	['Office C']
28-11-1997 to 31-3-2002	[Address concealed]	['Office D']
24-11-1999 to 17-10-2000	[Address concealed]	['Office E']
18-10-2000 to 15-7-2002	[Address concealed]	['Office F']

- (4) (a) The Firm's profit and loss accounts for the years ended 31 March 1997 to 2002 showed, inter alia, the following particulars:

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	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>
	\$	\$	\$	\$	\$	\$
Professional fee	4,233,519	6,286,638	4,213,191	4,557,605	4,287,800	3,883,223
Interest income	43,022	75,318	47,736	22,881	51,390	13,398
Other income	-	<u>11,268</u>	-	-	-	-
	<u>4,276,541</u>	<u>6,373,224</u>	<u>4,260,927</u>	<u>4,580,486</u>	<u>4,339,190</u>	<u>3,896,621</u>
<u>Less: Expenses</u>						
Accountant fee	-	-	8,000	9,000	-	1,000
Advertising	-	12,258	9,795	7,700	14,922	-
Audit fee	11,000	10,000	-	-	-	-
Bad Debts	-	4,335	-	-	-	-
Bank charges	-	-	-	-	-	6,898
Bank interest	-	-	-	-	-	6,246
Bank interest and charges	3,431	3,947	8,641	26,734	4,253	-
Building management fee	57,736	-	-	86,412	78,167	-
Business registration fee	2,673	5,822	2,174	3,219	3,219	-
Cleaning expenses	7,563	14,456	13,800	-	-	-
Consultancy fee	-	-	41,172	-	-	-
Consumable stores	112,105	-	-	-	-	-
Contribution	-	-	-	-	-	1,500
Courier and transportation expenses	-	12,868	16,699	179,623	43,557	-
Depreciation	5,954	21,266	28,879	28,879	20,067	-
Donation	-	-	-	10,000	-	-
Dues and subscriptions	-	-	-	-	27,671	-
Education fee	-	-	-	-	76,982	-
Electricity & water	36,796	-	-	-	-	14,024
Entertainment	373,363	709,311	471,190	432,548	331,072	131,502
Filing fee	-	-	-	-	-	105
Insurance	58,906	98,271	124,035	74,794	99,481	169,321
Land and Company search fee	146,697	33,966	54,864	55,166	-	-
Legal library	-	-	-	-	2,625	3,950
Legal and professional fee	126,716	72,435	40,584	-	-	-
Management fee	2,100,000	2,900,000	1,560,000	2,000,000	2,100,000	2,200,000
Medical expenses	95,960	23,016	7,506	27,083	17,733	19,975
Messing	72,886	298,356	130,245	144,291	122,335	86,117
Motor car running expenses	-	-	-	-	-	18,962
Office expenses	-	156,601	24,555	55,596	26,091	91,653
Operating lease charges	38,430	46,116	23,058	-	-	-
Postage	66,390	206,744	113,588	49,325	78,792	-
Printing and stationery	172,202	230,911	57,058	76,971	47,250	7,768
Rent & rates	-	-	-	88,948	162,153	-
Rent, rates and management fees	-	-	-	-	-	246,635

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	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>
	\$	\$	\$	\$	\$	\$
Repairs and maintenance	8,221	113,413	36,223	106,196	92,432	3,198
Salaries	421,648	783,680	1,314,094	796,648	709,820	603,539
Search fee	-	-	-	-	60,411	38,098
Seminar fee	-	-	43,582	67,480	-	-
Staff cost: mandatory provident fund	-	-	-	-	-	27,654
Stamping fee	-	-	-	-	-	14,160
Subscriptions	85,691	21,346	47,674	42,839	-	30,632
Sundry expenses	17	21,670	107,852	123,699	68,578	58,770
Tax Fee	1,400	-	-	-	-	-
Telephone and fax	364	95,684	49,325	-	-	11,807
Training	-	-	-	-	-	2,230
Traffic fee	72,268	190,925	15,204	51,544	53,174	37,976
Travelling	251,457	302,945	67,224	25,727	97,724	84,674
Utilities expenses	-	<u>70,322</u>	<u>102,049</u>	<u>56,958</u>	<u>44,768</u>	-
	<u>4,329,874</u>	<u>6,460,664</u>	<u>4,519,070</u>	<u>4,627,380</u>	<u>4,383,277</u>	<u>3,918,394</u>
Loss for the year	<u>(53,333)</u>	<u>(87,440)</u>	<u>(258,143)</u>	<u>(46,894)</u>	<u>(44,087)</u>	<u>(21,773)</u>

(b) The Firm declared the following assessable profits/adjusted losses in its Profits Tax returns:

	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>
	\$	\$	\$	\$	\$	\$
Assessable Profits	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>
Adjusted Loss	<u>(48,768)</u>	<u>(132,905)</u>	<u>(272,603)</u>	<u>(23,778)</u>	<u>(29,783)</u>	<u>(38,717)</u>

Copies of the Firm's Profits Tax returns, financial statements and tax computations for the years of assessment 1996/97 to 2001/02 are at Appendices A1 to A6 respectively.

- (5) Mr J derived total income of \$324,865 from the Firm for the year of assessment 1996/97.
- (6) On divers dates, the Assessor raised on the Firm the following Profits Tax assessments:

	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>
	\$	\$	\$	\$	\$	\$
Loss per Fact (4)(b)	(48,768)	(132,905)	(272,603)	(23,778)	(29,783)	(38,717)
<u>Add:</u> Salaries to partner [Fact (5)]	324,865	-	-	-	-	-

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	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>
	\$	\$	\$	\$	\$	\$
Non-deductible expenses	-	-	-	-	571,556 ³	-
Management fee	<u>700,000</u>	<u>966,666</u>	<u>520,000</u>	<u>666,666</u>	<u>700,000</u>	<u>847,750</u>
Assessable Profits	<u>976,097</u>	<u>833,761</u>	<u>247,397</u>	<u>642,888</u>	<u>1,241,773</u>	<u>809,033</u>
Tax Payable thereon	<u>146,414</u> ⁴	<u>112,557</u> ⁴	<u>37,109</u>	<u>96,433</u>	<u>186,265</u>	<u>121,354</u>

³ Non-deductible expenses comprised part of the building management fee, utilities expenses, rent and rates, traffic fee, traveling expenses, postage, messing, insurance and entertainment expenses.

⁴ Tax was not demanded at the time when the Profits Tax assessment was issued as Mr A elected Personal Assessment. Subsequently, there were changes in the Personal Assessment status of Mr A and profits tax was then demanded on the Firm.

(7) The Firm objected against the Profits Tax assessments for the years of assessment 1996/97 to 2001/02 on the grounds that they were excessive.

(8) In reply to the Assessor's enquiries, the Firm asserted that management fees as charged in its accounts [Fact (4)(a)] were paid to the following companies:

	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>
	\$	\$	\$	\$	\$	\$
Company B	2,000,000	2,760,000	1,460,000	1,850,000	2,000,000	2,100,000
Company C	50,000 ⁵	-	-	-	-	-
Company D	<u>100,000</u>	<u>140,000</u>	<u>100,000</u>	<u>150,000</u>	<u>100,000</u>	<u>100,000</u>
Total	<u>2,150,000</u> ⁶	<u>2,900,000</u>	<u>1,560,000</u>	<u>2,000,000</u>	<u>2,100,000</u>	<u>2,200,000</u>

⁵ The Firm later stated that no management fees were paid to Company C for the year of assessment 1996/97 [Fact (16)(b)].

⁶ Total management fee expense charged in the accounts of the Firm was \$2,100,000 for the year of assessment 1996/97 [Fact (4)(a)].

[Company B, Company C and Company D collectively as 'the Service Companies']

(9) Information about Company B

(a) Company B was incorporated in Hong Kong as a private Company on 3 June 1988. It made up its accounts to 31 March annually.

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- (b) At all relevant times, Mr A and his brother, Mr G ['Brother 1'], were the only two directors and shareholders of Company B.
- (c) At all material times, the registered office of Company B was situated at Office A.
- (d) In its reports of the directors for the years ended 31 March 1997 to 2002, Company B described its principal activities as follows:

	<u>Year ended 31 March</u>
1997 to 1999	: provision of management services and property investment;
2000	: investment properties holding and provision of management services; and
2001	: provision of management services as well as properties owning for rental purpose.

- (e) During the period from 1 April 1996 to 31 March 2002, Company B held the following properties:

<u>Location of property</u>	<u>Date of purchase</u>
(i) Address L ['the Quarters']	4-7-1988
(ii) Address M ['Property M']	8-11-1991
(iii) Office D	21-2-1992
(iv) Address N ['Property N']	22-4-1992
(v) Office A	30-9-1992
(vi) Office B	25-1-1995
(vii) Address P ['the Godown']	29-9-2001*

* acquired from Company D [Fact (11)(e)(iii)]

- (f) Company B provided the Quarters to Mr A as director's quarters for the years of assessment 1996/97 to 2001/02.

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- (g) (i) At all relevant times, all of the properties in Fact (9)(e), except Property M and the Godown, were pledged to banks or financial institutions.
- (ii) By a legal charge dated 24 October 2001, the Godown was used to secure general credit facilities.
- (h) Company B's profit and loss accounts for the years ended 31 March 1997 to 2002 showed the following particulars:

	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>
	\$	\$	\$	\$	\$	\$
Management fee income	2,000,000	2,760,000	1,460,000	1,850,000	2,000,000	2,100,000
Rental income	532,758	129,000	88,333	105,507	94,500	75,000
Other income	-	-	-	14,000	675	1,332
	<u>2,532,758</u>	<u>2,889,000</u>	<u>1,548,333</u>	<u>1,969,507</u>	<u>2,095,175</u>	<u>2,176,332</u>
<u>Less: Expenses</u>						
Advertising	65,315	17,332	-	7,700	-	81,582
Audit fee	6,000	6,000	6,000	5,000	4,500	9,800
Bank charges & overdraft interest	122,804	178,993	296,409	196,975	172,076	117,111
Bank loan interest	1,247,097	1,326,950	1,198,562	1,016,524	998,867	754,844
Book and periodicals	43,330	12,130	-	-	-	-
Building management fee	94,005	122,003	118,729	55,558	52,152	116,398
Business registration fee	2,250	2,250	2,250	2,250	2,250	2,250
Cleaning	13,800	-	-	-	-	-
Consultancy fee	316,380	438,672	-	-	-	-
Courier	-	-	-	4,787	-	9,556
Depreciation	351,753	427,103	440,703	447,566	455,756	347,187
Director's emoluments	90,000	100,000	100,000	148,000 ⁷	133,200	135,200
Donation	-	-	-	10,000	-	-
Education fee	39,740	32,394	-	-	-	-
Electricity and water	57,819	-	-	-	-	-
Entertainment	385,185	384,262	-	53,452	18,968	162,860
Equipment rental	-	-	-	-	-	2,775
Hire charges	13,211	24,535	9,436	-	-	-
Insurance	44,894	37,786	22,309	14,752	10,248	-
Loss on disposal of fixed assets	22,000	-	-	-	-	-
Mandatory provident fund	-	-	-	-	-	14,000
Medical scheme	-	-	-	2,433	475	-
Motor vehicle running expenses	-	-	-	-	-	13,854
Overseas travelling	-	-	-	22,742	6,913	25,400
Printing and stationery	28,530	-	13,513	69,290	3,911	57,608
Professional fee	67,400	17,600	-	-	-	-
Rent and rates	75,319	58,666	57,953	89,776	31,917	38,786
Repair and maintenance	82,574	-	-	74,580	17,720	42,545
Salaries and allowances	558,003	589,002	1,198,645	786,289 ⁷	310,542	281,585
Staff welfare	52,835	76,938	-	-	-	-
Subscription	-	-	-	34,785	15,765	4,000
Sundry expenses	57,834	83,743	14,850	19,213	15,747	17,790
Telephone and postage	44,802	-	-	44,530	11,105	22,758

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	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>
	\$	\$	\$	\$	\$	\$
Traffic fee	-	-	-	1,500	-	-
Transportation	-	-	-	6,325	21,844	3,300
Travelling	21,730	25,796	-	-	-	-
Utilities expenses	-	-	-	79,748	27,291	41,018
	<u>3,904,610</u>	<u>3,962,155</u>	<u>3,479,359</u>	<u>3,193,775</u>	<u>2,311,247</u>	<u>2,302,207</u>
Loss for the year	<u>(1,371,852)</u>	<u>(1,073,155)</u>	<u>(1,931,026)</u>	<u>(1,224,268)</u>	<u>(216,072)</u>	<u>(125,875)</u>

⁷ Being salaries and allowances of \$934,289 less directors' emoluments of \$148,000 (as shown in the comparative figure of accounts for the year ended 31-3-2001).

- (i) Company B declared the following assessable profits/adjusted losses in its Profits Tax returns:

	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>
	\$	\$	\$	\$	\$	\$
Assessable Profits	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>
Adjusted Loss	<u>(1,411,077)</u>	<u>(1,031,087)</u>	<u>(1,996,497)</u>	<u>(1,203,824)</u>	<u>(193,403)</u>	<u>(200,592)</u>

Copies of Company B's financial statements and proposed tax computations for the years of assessments 1996/97 to 2001/02 are at Appendices B1 to B6 respectively.

- (j) Company B filed employer's returns in respect of its directors and employees for the years of assessment 1996/97 to 2001/02, and reported the following particulars:

		<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>
	Capacity	\$	\$	\$	\$	\$	\$
MrA	Director	-	100,000 ⁸	100,000	148,000 ⁸	133,200 ⁸	135,200 ⁸
The Wife	Manager	-	100,000	108,000	108,000	108,000	108,000
Employee Q	Domestic helper	46,501	49,937	49,846	50,602	46,387	56,380
Employee R	Domestic helper	48,658	49,285	48,715	49,724	44,029	38,933
Mr J	Solicitor	-	179,848 ⁹	406,315 ¹⁰	195,325 ¹¹	-	-
Ms K	Solicitor	-	-	585,767 ¹⁰	382,638 ¹¹	-	-
Employee S	Clerk	-	30,000 ⁹	-	-	-	-
Employee T	Manager	-	100,000 ⁹	-	-	-	-
Employee U	Secretary	-	57,432 ⁹	-	-	-	-
Employee V	Clerk	-	22,500 ⁹	-	-	-	-
Total		<u>95,159</u>	<u>689,002</u>	<u>1,298,643</u>	<u>934,289</u>	<u>331,616</u>	<u>338,513</u>

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⁸ A place of residence at the Quarters was provided.

⁹ Total being \$389,780.

¹⁰ Total being \$992,082.

¹¹ Total being \$577,963.

(k) Total amounts of remunerations as furnished in employer's returns [Fact (9)(j)] reveal the following discrepancies as compared with those of directors' emoluments and salaries and allowances as charged in the accounts of Company B [Fact (9)(h)]:

	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>
	\$	\$	\$	\$	\$	\$
Per accounts:						
Director's emoluments	90,000	100,000	100,000	148,000	133,200	135,200
Salaries and allowances	<u>558,003</u>	<u>589,002</u>	<u>1,198,645</u>	<u>786,289</u>	<u>310,542</u>	<u>281,585</u>
Total	648,003	689,002	1,298,645	934,289	443,742	416,785
Total remunerations per Fact (9)(j)	<u>95,159</u>	<u>689,002</u>	<u>1,298,643</u>	<u>934,289</u>	<u>331,616</u>	<u>338,513</u>
Discrepancy	<u>552,844</u>	<u>0</u>	<u>0</u> ¹²	<u>0</u>	<u>112,126</u>	<u>78,272</u>

¹² Discrepancy of \$2 regarded as negligible.

(10) Information about Company C

- (a) Company C was incorporated in Hong Kong as a private company on 31 March 1994. It made up its accounts to 31 March annually.
- (b) At all relevant times, Mr A and the Wife were the only two directors of the company and shareholders of Company C.
- (c) At all material times, the registered office of Company C was situated at Office A.
- (d) In its report of the directors for the year ended 31 March 1997, the principal activities of Company C were stated as property investment and provision of management services. It was also stated that Company C received management fee income of \$40,000 from the Firm for the year of assessment 1996/97.
- (e) Company C's profit and loss account for the year ended 31 March 1997 showed the following particulars:

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	\$
Management fee income	40,000
Rental income	117,514
Other income	<u>579</u>
	<u>158,093</u>
<u>Less: Expenses</u>	
Accountancy fee	716
Auditors' remuneration	4,000
Bank charges	1,534
Bank overdraft interest	4
Bank loan interest	28,635
Building management fee	39,892
Business registration fee	2,250
Entertainment	17,000
Foreign tax on property	13,489
Printing and stationery	3,868
Repairs and maintenance	13,663
Sundry expenses	<u>1,584</u>
	<u>126,635</u>
Profit for the year	<u>31,458</u>

Copies of Company C's financial statements and tax computations for the year of assessment 1996/97 are at Appendix C.

- (f) Company C declared assessable profits of \$9,473 in its Profits Tax return for the year of assessment 1996/97.

(11) Information about Company D

- (a) Company D was incorporated in Hong Kong as a private company on 6 November 1990. It made up its accounts to 31 March annually.
- (b) At all relevant times, Mr A and the Wife were the only two directors and shareholders of Company D.
- (c) At all material times, the registered office of Company D was situated at Office A.
- (d) In its Profits Tax returns for the years of assessment 1996/97 to 2001/02, Company D declared its principal activities as follows:

Year ended 31 March

1997, 1999 to 2002 : provision of management services; and

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Year ended 31 March

1998 : property investment and provision of translation service.

- (e) During the period from 1 April 1996 to 31 March 2002, Company D held the following properties:

Location of property	Purchase		Sale
	<u>Date of purchase agreement</u>	<u>Date of assignment</u>	<u>Date of assignment</u>
(i) Address W [‘Property W’]	10-12-1993	28-2-1994	18-6-1996
(ii) Office C	25-11-1996	31-1-1997	29-8-2003*
(iii) The Godown	2-12-1993	30-7-2001	29-9-2001**

* sold to Company C

** sold to Company B [Fact (9)(e)(vii)]

- (f) At all relevant times, Office C and Property W were used to secure general banking facilities.
- (g) Company D’s profit and loss accounts for the years ended 31 March 1997 to 2002 showed the following particulars:

	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>
	\$	\$	\$	\$	\$	\$
Service fee income	<u>100,000</u>	<u>140,000</u>	<u>100,000</u>	<u>100,000</u>	<u>150,000</u>	<u>100,000</u>
<u>Less: Expenses</u>						
Accounting fee	-	-	-	3,600	-	-
Audit fee	3,000	4,000	3,000	3,000	3,000	3,000
Bank charges	20	120	500	-	-	1,000
Bank loan interest	7,857	86,590	89,656	17,719	7,180	33,408
Building management fee	8,565	-	8,700	9,000	9,000	2,400
Business registration fee	2,250	2,550	2,250	2,250	2,250	2,250
Depreciation	20,432	43,602	40,865	40,865	40,865	26,328
Entertainment	15,003	-	15,002	-	-	-
Insurance	6,680	4,122	1,260	868	9,295	517
Loss on disposal of fixed assets	84,599	-	-	-	1	360,512
Mortgage loan interest	-	-	-	74,374	60,726	-
Other loan interest	50,161	41,528	33,368	-	-	-

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	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>
	\$	\$	\$	\$	\$	\$
Printing and stationeries	3,918	-	-	651	1,006	1,156
Rates	7,527	6,240	9,794	7,680	11,646	6,669
Repairs and maintenance	-	-	-	200	780	-
Telephone	954	-	-	1,302	3,478	3,584
Water, gas and electricity	<u>345</u>	<u>1,280</u>	<u>4,181</u>	<u>1,153</u>	<u>3,203</u>	<u>6,801</u>
	<u>211,311</u>	<u>190,032</u>	<u>208,576</u>	<u>162,662</u>	<u>152,430</u>	<u>447,625</u>
Loss for the year	<u>(111,311)</u>	<u>(50,032)</u>	<u>(108,576)</u>	<u>(62,662)</u>	<u>(2,430)</u>	<u>(347,625)</u>

- (h) Company D declared the following assessable profits/adjusted losses in its Profits Tax returns and Profits Tax computations:

	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>
	\$	\$	\$	\$	\$	\$
Assessable Profits/ (Adjusted Loss)					360	
	<u>(26,448)</u>	<u>(27,457)</u> ¹³	<u>(105,787)</u>	<u>(59,873)</u>		<u>(17,485)</u>
<u>Less:</u> Loss set-off					<u>(360)</u>	
Net Assessable Profits	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>
Loss b/f	-	26,448	53,905	159,692	219,565	219,205
<u>Add:</u> Loss for the year	26,448	27,457	105,787	59,873	-	17,485
<u>Less:</u> Loss set-off	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(360)</u>	<u>-</u>
Loss c/f	<u>26,448</u>	<u>53,905</u>	<u>159,692</u>	<u>219,565</u>	<u>219,205</u>	<u>236,690</u>

¹³ Adjusted loss after depreciation allowance per tax computations.

Copies of Company D's financial statements and tax computations for the years of assessment 1996/97 to 2001/02 are at Appendices D1 to D6 respectively.

- (12) In correspondence with the Assessor, the Firm put forward the following assertions in respect of its payments of the management fees in Fact (8) above:

In relation to Company B

- (a) On divers dates, the Firm entered into management and consultancy agreements with Company B whereby Company B agreed, among others, to provide the Firm fully furnished office premises and consultancy service.
- (b) In consideration of the services provided by Company B, the Firm agreed to pay to Company B management fees.
- (c) Some details of the agreements are set out below:

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Appendix	E1	E2	E3	E4	E4.1	E5	E6
Date of agreement	1-4-1996	1-4-1997	1-4-1998	1-4-1999	1-11-1999	1-4-2000	1-4-2001
Period covered	1-4-1996 to 31-3-1997	1-4-1997 to 31-3-1998	1-4-1998 to 31-3-1999	1-4-1999 to 31-3-2000	[Note (a)]	1-4-2000 to 31-3-2001	1-4-2001 to 31-3-2002
Provision of							
- office premises at	Office A & Office B	Office A, Office B & Office D	Office A, Office B & Office D	Office A, Office B & Office D	Office E	Office A, Office B & Office D	Office A, Office B & Office D
- consultancy service	yes	yes	yes	yes	[Note (a)]	yes	yes
Annual management and consultancy fee	Not less than \$2,000,000 but not exceeding \$3,000,000 [Note (b)]			Not less than \$1,500,000 but not exceeding \$2,000,000 [Note (b)]	[Note (a)]	Not less than \$2,000,000 but not exceeding \$3,000,000 [Note (c)]	
Agreement entered into by							
- the Firm represented by	Mr A	Mr A	Mr A	Mr A	Mr A	Mr A	Mr A
- Company B represented by	Brother 1	Brother 1	Brother 1	Brother 1	Brother 1	Brother 1	Brother 1
Agreement witnessed by	The Wife	The Wife [Note (d)]	The Wife [Note (d)]	The Wife	The Wife	The Wife [Note (d)]	The Wife [Note (d)]

Note:

- (a) This agreement was supplemental to the agreement dated 1 April 1999 at Appendix E4. The provision of the office premises at Office E was added while all other terms of the agreement dated 1 April 1999 remained the same.
- (b) To be adjusted according to actual business turnover of the Firm.
- (c) To be adjusted according to actual business turnover of the Firm and other economic factors.
- (d) As solicitor of Hong Kong Special Administrative Region [‘HKSAR’]

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In relation to Company C

- (d) By an agreement dated 1 April 1996 [Appendix F], Company C agreed to provide to the Firm for its use of law textbooks, journals and research materials for the period from 1 April 1996 to 31 March 1997.
- (e) In consideration of the services provided by Company C, the Firm agreed to pay to Company C an annual service fee of \$50,000.

In relation to Company D

- (f) On divers dates, the Firm entered into management and consultancy agreements with Company D whereby Company D agreed, among others, to provide to the Firm godown facilities, translation services of legal documents and fully furnished office premises.
- (g) The Firm entered into management and consultancy agreements with Company D. Some details of the agreements are set out below:

Appendix	G1	G2	G3	G4	G5	G6
Date of agreement	1-4-1996	1-4-1997	1-4-1998	1-4-1999	1-4-2000	1-4-2001
Period covered	1-4-1996 to 31-3-1997	1-4-1997 to 31-3-1998	1-4-1998 to 31-3-1999	1-4-1999 to 31-3-2000	1-4-2000 to 31-3-2001	1-4-2001 to 31-3-2002
Provision of						
- office premises at	-	Office C	Office C	Office C	Office C	Office C
- godown facilities at	The Godown	The Godown	The Godown	The Godown	The Godown	The Godown
- translation services	yes	yes	yes	yes	yes	yes
Annual management and consultancy fee	Not less than \$100,000 but not exceeding \$200,000 [Note (e)]				Not less than \$100,000 but not exceeding \$200,000 [Note (f)]	

Note:

- (e) To be adjusted according to actual business turnover of the Firm.
- (f) To be adjusted according to actual business turnover of the Firm and other economic factors.

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(13) In his Individual's Tax Return for the year of assessment 1996/97, Mr A declared a total income of \$108,000 from Company B for the year ended 31 March 1997 with a place of residence at the Quarters provided by Company B for the year.

(14) With regard to the claim for deduction of management fees for the years of assessment 1996/97 to 2001/02, the Firm and through Company H ['the Representatives'] put forward the following assertions and arguments:

(a) 'The management fee claimed is genuinely incurred and is thus lawful and legitimate. The said management fee was necessarily incurred in return for, inter alia, provision of furnished office premises to our firm. As such, Practice Direction 24 is not applicable to our case.'

(b) 'The management fee charged to [the Firm in respect of the year of assessment 2001/02] is calculated as follows:

	Office rental per month	Equipment rental per month	General management per month	Total per month
[Office A]	60,000	20,000	10,000	90,000
[Office B]	35,000	10,000	10,000	55,000
[Office D]	<u>15,000</u>	<u>5,000</u>	<u>10,000</u>	<u>30,000</u>
	<u>110,000</u>	<u>35,000</u>	<u>30,000</u>	<u>175,000</u>
			Per annum	<u>2,100,000</u>

As the above income was charged at arm's length, we considered that no adjustment should be made as stipulated in the Departmental Interpretation & Practice Notes No. 24 ['DIPN No. 24'].'

(c) 'Your [DIPN No. 24] would appear to apply fictitious or artificial scheme and is not applicable to this case.'

(d) The Firm employed Mr A's another brother, Mr E ['Brother 2'], as clerk and the following salaries expenses were charged in the Firm's accounts in respect of Brother 2:

<u>Year of assessment</u>	<u>Period covered</u>	<u>Amount</u> \$
1997/98	1-1-1998 to 31-3-1998	30,000
1998/99	1-4-1998 to 31-3-1999	118,400
1999/2000	1-4-1999 to 31-3-2000	114,300

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- (15) By various letters, the Assessor requested the Firm to supply, among others, details of the following expenses:
- (a) medical expenses of the Firm for the years of assessment 1996/97 to 2000/01;
 - (b) bank charges and interest, bank loan interest, building management fees, electricity and water/utilities expenses, rent and rates of Company B for the years of assessment 1996/97 to 2001/02;
 - (c) salaries and allowances of Company B for the years of assessment 1996/97 to 2001/02;
 - (d) repairs and maintenance of Company B for the years of assessment 1996/97, 1999/2000 to 2001/02; and
 - (e) bank loan interest of Company D for the year of assessment 1999/2000 and other loan interest for 1996/97 to 1998/99.
- (16) The Assessor raised further enquiries on 14 April 2008 [Appendix I] and requested for, inter alia, the following further information and documents:
- (a) The bases of computations of minimum management fees as set out in the purported management and consultancy agreements that the Firm had entered into with Company B and Company D for the years of assessment 1996/97 to 2001/02.
 - (b) Reconciliation of the bases of adjustments of the management fees chargeable on the Firm by Company B and Company D against the management fees expenses charged in the accounts of the Firm in Fact (8).
 - (c) Details of Brother 2's employment with Company B including his academic and professional qualification.
 - (d) Details of the staff of the Firm in respect of whom medical expenses were incurred for the years of assessment 1996/97 to 2001/02.
 - (e) A detailed breakdown of the salaries and allowances charged in the accounts of Company B for the years of assessment 1996/97, 1998/99, 2000/01 and 2001/02 [Fact (9)(h)].
 - (f) The usage of Property M by Company B during the years of assessment 1996/97 to 2000/01.
 - (g) The usage of Property W by Company D for the year of assessment 1996/97.

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(17) In response to the Assessor's above enquiries, the Firm put forward the following assertions:

(a) 'The circumstances under which the adjustment was to be made [on the management fees chargeable on the Firm by Company B] would include number of office premises to be provided by [Company B] for the Firm's use and occupation and the frequency of the other services provided, i.e. legal and marketing consultancy advices provided by [Company B] to the Firm during the relevant year and last, but not the least, economic factors.'

(b) 'The minimum management fee of HK\$100,000.00 is the reasonable return to [Company D] for provision of the storage go-down and the other services for the Firm as mentioned in the Agreements [at Appendices G1 to G6]. [Company D] has to incur mortgage interest and operation costs in order to provide such services to the Firm.'

(18) The Firm provided the following information and documents:

(a) Copies of schedules ['the Schedules', at Appendices J1 to J3] furnished by the Firm to The Law Society of Hong Kong ['the Law Society'] which showed, inter alia, the following:

(i) Brother 2 was the Firm's employee for the years ended 31 December 1999 and 2001; and

(b) Salaries and allowances in the total amounts of \$503,481.84 and \$1,972,763.10 were paid by Company B to its employees for the respective years of assessment 1996/97 and 1998/99.

Copies of the breakdowns are at Appendices K1 and K2 respectively.

(c) Property M was used by Company B as staff quarters for the years of assessment 1996/97 to 2000/01.

(d) Copies of bank transfer slips [Appendix L] which showed the following payments of funds from the Firm to Company B during the period from 25 April 1997 to 31 March 1998:

<u>Date</u>	<u>Amount transferred to Company B</u>
	\$
25-4-1997	63,825.00
29-4-1997	7,035.00
1-5-1997	324,275.00
2-5-1997	161,625.00

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<u>Date</u>	<u>Amount transferred to Company B</u>
	\$
5-5-1997	100,000.00
6-5-1997	51,300.00
7-5-1997	28,150.00
12-5-1997	59,535.00
15-5-1997	42,500.00
21-5-1997	45,000.00
4-7-1997	74,984.00
7-7-1997	56,816.25
8-7-1997	57,000.00
18-7-1997	82,000.00
25-7-1997	23,000.00
29-7-1997	50,000.00
6-8-1997	31,000.00
7-8-1997	10,000.00
11-8-1997	58,000.00
16-8-1997	200,000.00
25-8-1997	57,000.00
28-8-1997	167,000.00
4-9-1997	60,000.00
8-9-1997	30,000.00
12-9-1997	37,000.00
22-9-1997	585,000.00
15-10-1997	55,000.00
16-10-1997	112,000.00
17-10-1997	50,000.00
23-10-1997	53,000.00
28-10-1997	27,000.00
31-10-1997	124,000.00
6-11-1997	90,000.00
10-11-1997	19,000.00
14-11-1997	27,000.00
19-11-1997	110,000.00
18-3-1998	17,000.00
19-3-1998	39,000.00
23-3-1998	74,500.00
27-3-1998	101,500.00
31-3-1998	39,500.00
Total	<u>3,400,545.25</u>

- (e) Property W was used by Company D as holiday house for staff members during the period from 1 April 1996 to 18 June 1996.