

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D144/98

Profits Tax – allowable deductions – whether taxpayer entitled to deduct the sum of investments in ascertaining profits – sections 16(1)(d) and 17(1)(c) of the Inland Revenue Ordinance.

Panel: Andrew Halkyard (chairman), Daniel Cheung Kwok Chun and David Lam Tai Wai.

Date of hearing: 26 November 1998.

Date of decision: 7 January 1999.

The taxpayer carried on business as an audio-visual consultant during the period 26 February 1990 to early 1992. In the taxpayer's tax return for the years of profits tax assessments 1990/91 and 1991/92, the taxpayer sought to deduct sums of \$120,000 and \$50,000 as investment in two films produced by Company X. In support of this claim, the taxpayer provided two receipts signed by the proprietor of Company X, Mr Y. The taxpayer further stated that lack of formal agreements evidencing the payments was consistent with film industry practice, especially that of small production houses. The Commissioner refused to allow the deductions claimed and the taxpayer has lodged an appeal to the Board of Review against this decision.

The taxpayer gave evidence and it was the taxpayer's case that the two sums of money were simply to invest in, and profit from, a good box-office movie. The Commissioner argued that the amounts claimed to be invested in the two films by the taxpayer were simply loans arising from the facts that the taxpayer performed services for Company X for which he had not been paid and that he had separately advanced fund to Mr Y. In this event, the provisions of section 16(1)(d), allowing deductions for bad debts in certain circumstances, do not apply. Alternatively the amount 'invested' is in the nature of capital and is thus denied deduction under section 17(1)(c) of the Inland Revenue Ordinance (the IRO).

Held:

Having heard and observed the evidence given by the taxpayer, on a balance of probabilities, the Board found it much more likely than not that the amounts in dispute represented sums owed by Mr Y to the taxpayer for services rendered to Company X and/or represented moneys loaned to Mr Y by the taxpayer. To the extent that they represented unpaid remuneration, their loss has no tax effect. To the extent that they represented a loan, their loss does not qualify for deduction under any of the provisions allowed by the IRO.

INLAND REVENUE BOARD OF REVIEW DECISIONS

Appeal dismissed.

Wong Ki Fong for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. This is an appeal by the Taxpayer against profits tax assessments raised on him for the years of assessment 1990/91 and 1991/92. The Taxpayer claims that certain deductions should be made in the computation of his assessable profits.

The facts

2. The agreed facts, which we so find, are set out in a document entitled 'profits tax assessments 1990/91, 1991/92'. A bundle of agreed documents was attached to the agreed statement of facts.

3. The Taxpayer gave evidence before us. On the basis of that evidence, and the documents placed before us, we find the following additional facts.

1. The Taxpayer carried on business as an audio-visual consultant during the period 26 February 1990 to early 1992.
2. The Taxpayer derived income of \$72,000 from Company X, a film production company for four months work during the period September to December 1990. This sum was paid to and received by the Taxpayer.
3. The Taxpayer also worked for Company X in the year ended 31 March 1992. He did not receive any payment for this work. The Taxpayer could not recall how many months he worked for Company X during this year. But he estimated that during this year Company X owed him at least \$300,000. The Taxpayer did not enter into any formal service agreement with Company X.
4. In his profits tax returns the Taxpayer recorded total income of \$132,000 and \$54,166 for the years of assessment 1990/91 and 1991/92 respectively. Against these amounts the Taxpayer sought to deduct sums of \$120,000 and \$50,000 respectively. He described these sums as investment in two films produced by Company X. The Taxpayer claims that he paid these sums in cash. In support of this claim the Taxpayer was only able to provide two receipts signed by the proprietor of Company X, Mr Y. He had no other evidence to support this claim, apart from stating that lack of formal agreements evidencing the payments was consistent

INLAND REVENUE BOARD OF REVIEW DECISIONS

with film industry practice, especially that of small production houses. He had no bank records to support any withdrawals made prior to the payments.

5. Company X produced a film during the year ended 31 March 1991. The Taxpayer worked on this film while performing services for Company X. During this year the Taxpayer cannot recall working on any other film for Company X. Another film commenced production during the year ended 31 March 1992 (it was not clear from the evidence whether the film was completed). During this year the Taxpayer cannot recall working on any other film for Company X. But he did state that he helped Mr Y run the office of Company X and that he spent a lot of time in doing so.
6. It was unclear from the Taxpayer's evidence on what basis he expected to receive any return from Mr Y if the two films were a success at the box office. Such informal arrangements were, according to the Taxpayer, based simply upon trust. It was implicit from his evidence that Mr Y would pay him some amount in addition to repaying his claimed 'investments' if the films turned out to be successful. However, the Taxpayer would never know the basis of any such payment because he would not have been given access to the box office returns for the films produced by Company X.
7. The Taxpayer stated that he was not liable to share the burden of any losses from the films, apart from losing the sums he claimed to have invested in them.
8. The Taxpayer could not adequately explain why his tax representative, a Certified Public Accountant, stated to the assessor that the amounts invested in the films 'are actually the fee for [Company X] hiring [the Taxpayer's services].'
9. Neither could the Taxpayer adequately explain his statement in his notice of appeal that 'The amount of \$120,000 and \$50,000 was in the form of cash given to [Mr Y] plus the salary that Mr Y owed me.' (emphasis added) He could only suggest that he did not have a complete memory of his dealings with his tax representative who may have mixed up the information on his investment with the unpaid salary owed to him by Mr Y.
10. At the time of Mr Y's death in late 1991, the Taxpayer claims that Mr Y owed him an amount of some \$300,000, representing unpaid salary for services performed (estimated to be \$200,000) and an outstanding loan (estimated to be \$100,000). This loan was made by the Taxpayer to Mr Y who needed funds for various activities relating to his film production

INLAND REVENUE BOARD OF REVIEW DECISIONS

business. The Taxpayer claims that this loan was a totally separate matter from his investment in the two films.

11. The Taxpayer could not adequately recall how, if at all, he made any attempt to recover any of the funds owed to him by Mr Y. He did, however, state that if he had regarded the sums invested in the two films as a loan, he would have made an attempt to recover the money in the event of non-payment.
12. The Taxpayer could not say in what capacity he advanced funds to Mr Y for investment in the two films. He did, however, state that 'for tax purposes, I would say that the investment was made in the company's name.'¹
13. The Commissioner has refused to allow the deductions claimed at fact 4 and the Taxpayer has lodged a valid appeal to the Board of Review against this decision.

Contentions for the Taxpayer

4. In essence, the Taxpayer reiterated his evidence before us. He claimed that Mr Y had difficulties in financing his film production business in the years of assessment relevant to this appeal. He claimed that he simply agreed to help Mr Y out, he gave him the sums in dispute in cash, and these payments were recorded in the receipts signed by Mr Y.

5. The Taxpayer stated that his dream was simply to invest in, and profit from, a good box-office movie. He denied that the amounts were loans advanced by him to Mr Y. He also denied that any part of the amounts represented sums owed to him by Mr Y for the services he performed for Company X.

Contentions for the Commissioner

6. On the basis of the documents before us, as well as the lack of corroborating evidence, the Commissioner argued that the amounts claimed to be invested in the two films by the Taxpayer were simply loans arising from the facts that he performed services for Company X for which he had not been paid (facts 8 and 9 refer) and that he had separately advanced funds to Mr Y (fact 10 refers). In this event, there is no provision in the Inland Revenue Ordinance that allows the Taxpayer a deduction for any bad debt. In particular, the provisions of section 16(1)(d), allowing deductions for bad debts in certain circumstances, do not apply. Alternatively, the amount 'invested' is in the nature of capital and is thus denied deduction under section 17(1)(c).

Reasons for decision

¹ Here, the Taxpayer was referring to fact 1 where he carried on business as a sole proprietor under his name.

INLAND REVENUE BOARD OF REVIEW DECISIONS

7. We have found this to be a difficult case because the documents before us (particularly those relating to facts 8 and 9) are in marked contrast with the Taxpayer's oral evidence that the amounts in dispute were completely separate from any amount owing to him for the services he rendered to Company X and from the loan he advanced to Mr Y.

8. At the outset we must state that we were generally impressed by the sincerity and demeanour of the Taxpayer in giving evidence before us. His evidence as to the informal nature of business dealings in the context of small film production houses had the ring of truth. It is not surprising therefore that no formal agreements evidenced the Taxpayer's dealings as a service provider to Company X, as a creditor to Mr Y and as an 'investor' (to use the Taxpayer's term) in financing the production of the two films.

9. Notwithstanding the above comments, the Taxpayer simply has not persuaded us that he paid the full amounts of \$120,000 and \$50,000 in cash to Mr Y for the production of the two films. In this regard, we accept that Mr Y provided the Taxpayer with receipts for these amounts. But we agree with the Commissioner that it does not follow that we must accept them at face value. In our view, when considered in the light of all the other evidence before us, it is more likely than not that the receipts simply record that Mr Y acknowledged an obligation to repay certain amounts to the Taxpayer.

10. How those amounts were credited to the Taxpayer is, in our view, the real issue to be decided in this appeal. The Taxpayer claims that they were cash payments made by him to Mr Y to finance production of the two films. He denied that the amounts were loans advanced by him to Mr Y. He also denied that any part of the amounts represented sums owed to him by Mr Y for the services he performed for Company X. But if we accepted all these contentions, we would have to overlook, or satisfactorily explain, all of the following: (1) the tax representative's contentions at fact 8 on behalf of the Taxpayer, (2) the Taxpayer's own notice of appeal and admission therein that part of the amounts in dispute represented salary owed to him by Mr Y, (3) that the Taxpayer made no effort to obtain bank or other records which could help reconcile the source of the amounts set out in the receipts, (4) the size of the alleged payments of \$120,000 and \$50,000 (although we accept the Taxpayer's evidence that cash payments were very much the norm within the film production industry, the Taxpayer never sought to claim that he carried such large amounts of cash with him or kept such large amounts at home) and (5) the fact that the Taxpayer was prepared to continue advancing large sums to Mr Y notwithstanding that Mr Y owed him significant amounts of money (facts 3 and 10 refer).

11. On the balance of probabilities, we think it much more likely that the amounts in dispute represented sums owed by Mr Y to the Taxpayer for services rendered to Company X and/or represented moneys loaned to Mr Y by the Taxpayer. To the extent that they represented unpaid remuneration, their loss has no tax effect – if such amount was deductible, a similar amount should also be added to the assessment as income dealt with on the Taxpayer's behalf. And, to the extent that they represented a loan, their loss does not qualify for deduction under any of the provisions allowed by Inland Revenue Ordinance.

INLAND REVENUE BOARD OF REVIEW DECISIONS

12. In reaching the above conclusion, we appreciate that, while accepting part of the Taxpayer's evidence in relation to practices prevalent in the film production industry, we reject that part where he stated that the amounts in dispute were all referable to cash payments he made to Mr Y for producing the two films. In this regard, we note generally that the Taxpayer's evidence was, in many respects, based upon an admitted faulty memory of salient facts and that his specific evidence relating to the amounts in dispute contrasts vividly with documentary evidence to the contrary, which was not satisfactorily explained away.

13. We do not doubt that, in an economic sense and from the Taxpayer's perspective, these amounts were 'invested' by the Taxpayer. But, in the event, the Taxpayer has not satisfied us that these sums took the form of cash payments, that they were wholly divorced from his other dealings with Mr Y and that they represented ordinary revenue expenses incurred in the course of his business as an audio-visual consultant.

14. We note for the record that the Taxpayer's notice of appeal also covered salaries tax assessments raised on him for the years of assessment 1993/94 and 1994/95. In this regard, the issue in dispute was totally separate from the profits tax assessments considered in this decision. At the conclusion of the Board hearing, the Taxpayer withdrew his appeal against the salaries tax assessments. It is thus not necessary for us to consider this matter further.

15. For all the above reasons this appeal is dismissed. It is left for us to thank the Taxpayer for his explanations and his arguments before us. We also thank the Commissioner's representative, Ms Wong Ki-fong, for her clear and helpful submission.