# Case No. D153/01

**Profits tax** – whether certain sums were deductible – onus of proof on the taxpayer that an expense was incurred for the production of his assessable profits – purpose of payments – whether the expense was bona fide incurred in the production of the chargeable profits – matter of fact and degree – whether a relevant transaction between the taxpayer and a service company was artificial within the ambit of section 61 – whether the sole and dominant purpose of enabling the taxpayer to obtain a tax benefit – sections 16, 17, 61, 61A and 68(4) of the Inland Revenue Ordinance ('IRO').

Panel: Anna Chow Suk Han (chairman), Edward Chow Kam Wah and Ng Yook Man.

Dates of hearing: 14 February and 19 March 2001.
Date of decision: 19 February 2002.

The taxpayer, a practicing barrister, appealed against a determination of profits tax assessments for the years of assessment 1994/95 to 1998/99. He claimed that the management fee charged against him by Company B, in which the taxpayer and a Ms E became directors and shareholders as from 18 October 1990, should be deducted from his assessable profits.

The facts appear sufficiently in the following judgment.

**Held:**

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

2. Section 16(1) of the IRO 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.

3. Section 17 of the IRO disallows deduction of certain types of outgoings and expenses.

4. If a taxpayer fails to prove that an expense was incurred for the production of his assessable profits, the whole of that expense will be disallowed. In the present case,

if the taxpayer was unable to prove that the management fees were incurred in the production of his assessable profits, the whole of these management fees would be disallowed.

5. But if an expense is capable of analysis and subdivision or where section 61 or section 61A of the IRO applies which allows dissection of the expenses, then that expense can be allowed 'to the extent' that it was incurred to produce the taxable profits and the balance thereof be disallowed.

6. In the present case, since the management fees were made up of those expenses as detailed in Company B's profits and loss accounts plus a mark-up of 5%, they were thus capable of analysis and subdivision. Accordingly, only those expenses which were proved to be incurred in production of the taxpayer's assessable profits would qualify as allowable deductions.

7. The Board decided that an examination of Company B's expenses in detail should be allowed.

8. The amounts of management fees were calculated by reference to all the expenses and outgoings incurred by Company B in providing the requisite services plus a mark-up of 5%. Examination of those expenses and outgoings was necessary as to determine whether they were incurred in production of the taxpayer's assessable profits.

9. In so doing, the Board was not lifting the corporate veil nor was the Board saying that the taxpayer was not free to decide his own affairs but the question of whether an expense is deductible in law when computing the chargeable profits must be answered objectively.

10. The Board must look into the purpose of the payments and see whether the expense was bona fide incurred in production of the chargeable profits.

11. The onus is on the taxpayer to show that each of those items of expenses in Company B's profits and loss accounts was bona fide incurred for the production of his assessable profits.

12. The Board was not persuaded by the contention of the taxpayer that since Company B's tax position was not in dispute, the expenses in Company B's accounts were the least relevant.

13. Nor did the Board accept the contention that once the taxpayer could establish that the management fees were incurred for the purpose of acquiring professional

services from Company B, the management fees should be allowed in full. The matter did not stop there. The taxpayer was still required to prove that the expenses were bona fide incurred for the production of his assessable profits.

14. In the assessment stage, the Commissioner had considered the various items of expenditure in Company B's accounts and had allowed for deduction of those items which reflected the costs attributable to the operation of the taxpayer's practice. The Board did not intend to disturb these deductions. As for the remaining items, the taxpayer was required to prove their deductibility.

15. The Board did not accept that entertaining judges and fellow barristers and the use of the clubs were for the production of the taxpayer's income.

16. The taxpayer is a barrister and by Bar Code of Conduct he is not allowed to tout for business. Entertainment expenses to the extent now claimed were inconsistent with such code of conduct for barristers.

17. The Board could not accept the expenses incurred by Ms E, the de facto personal assistant of the taxpayer, and booked as entertainment expenses in Company B's accounts were expenses for the production of the taxpayer's assessable profits.

18. Also, Ms E, who exclusively ran Company B and dealt with the accounting matters, did not give evidence. Thus, the Board had no way of understanding how Company B's accounts were kept, how the expenses were booked as entertainment expenses or director's allowances and how a distinction was drawn between expenses on a personal basis and expenses for business purposes. It followed that on the basis of the documentary and oral evidence before the Board, it was unable to find that the entertainment expenses in Company B's accounts were incurred for producing the taxpayer's chargeable profits.

19. In reaching this decision, the Board was also conscious of the adjustments which were said to have been made to the entertainment expenses. The adjustments were said to have made by way of discounting certain percentages of the total entertaining expenses which represented the expenses of personal nature. Since no witness was called to give evidence as to what adjustments and how the adjustments were made or how the percentages were arrived at, the Board could not accept that the amounts of entertainment expenses now appeared in Company B's accounts represented only those expenses for business purposes.

20. Even if the Board had evidence in this regard, the Board would have grave doubt as to the accuracy of the adjustments since the taxpayer gave evidence that he kept no record of nor did he draw distinction between entertainment expenses for personal

or business purposes. The adjustments could not be anything but arbitrary.

21. Although the Board was dealing with different types of expenses, directors' quarters expenses as opposed to medical expenses, they were similar in one aspect. Both expenses had a dual purpose, that of domestic and business. Thus, the Board derived assistance from the case of Anthony Patrick Fahy v CIR 3 HKTC 695 in deciding on the deductibility of the quarters' expenses.

22. It is a matter of fact and degree whether an expense was incurred in the production of assessable profits.

23. The taxpayer must have a place of residence. The rent and rates of the Road F premises and indeed the costs of the maid which were included in the quarters' expenses must be incurred whether or not the taxpayer used the premises for work purposes.

24. The Board was of the view that the taxpayer's works were carried out predominantly at his chamber. The use of the Road F premises for work purposes was only incidental. Under the circumstances, the Board found that the quarters' expenses were not incurred in the production of the taxpayer's income.

25. The quarters' expenses being 'domestic or private expenses' were also non-deductible under section 17(1)(a) of the IRO. Thus, the Board found that the directors' quarters expenses were not deductible expenses under the law.

26. The taxpayer did not adduce evidence nor was there documentary evidence to substantiate that the remaining items of expenditure as appeared in Company B's accounts were incurred in production of the taxpayer's income. Thus, those remaining items must also fail as deductible expenses under section 16(1) of the IRO.

27. Had it been necessary for the Board to consider section 61 or section 61A of the IRO, the Board would take the view that the transaction between the taxpayer and Company B arising out of the Service Agreement and the Employment Agreement was artificial within the ambit of section 61 of the IRO.

28. As to section 61A of the IRO, the Board also accepted the Commissioner's reasons in his determination to conclude that the Service Agreement and the Employment Agreement were entered into by the taxpayer and Company B for the sole and dominant purpose of enabling the taxpayer to obtain a tax benefit.

29. Each case has its own particular facts and the law is that the onus is on the appellant

to prove that the expenses were incurred for production of profits, failing which those expenses wholly or partly cannot be allowed.

**Appeal dismissed.**

Cases referred to:

Magna Alloys & Research Pty Ltd v FCT (1980) 80 ATC 4542
CEC v Comptroller of Income Tax [1971] SLR Lexis 68
D20/92, IRBRD, vol 7, 166
Europa Oil (NZ) Limited v Commissioner of Inland Revenue (No 2) [1976] 1 WLR 464
Mangin v Inland Revenue Commissioners [1971] AC 739
Anthony Patrick Fahy v CIR 3 HKTC 695

Robert Andrews Counsel instructed by Department of Justice for the Commissioner of Inland Revenue.
Neil Thomson Counsel instructed by Taxation and Financial Services Limited for the taxpayer.

**Decision:**

**The appeal**

1. This is an appeal by Mr A ('the Taxpayer') against the determination of the Commissioner of Inland Revenue of 31 July 2000. The Taxpayer has objected to the 1994/95 (additional), 1994/95 (second additional), 1995/96 (additional), 1995/96 (second additional), 1996/97 (additional), 1996/97 (second additional), 1997/98 (additional) and 1998/99 (additional) profits tax raised on him. He claims that in computing his assessable profits, the management fee charged against him by Company B should be fully allowed for deduction.

**The background facts**

2. The Taxpayer is and was, at all material times, a barrister practicing law in Hong Kong.

3. Company B was incorporated as a private company in Hong Kong on 29 July 1986. On 18 August 1986, Company B applied for business registration. Mr C, a barrister-at-law and Mrs D were the company's directors and shareholders between 5 September 1986 and 17 October 1990. The Taxpayer and Ms E became the company's directors and shareholders as from 18 October 1990.

4. As stated in its profits tax returns for the years of assessment 1994/95 and 1995/96, Company B's business address was at the Taxpayer's chambers and in its profits tax returns for the years of assessment 1996/97 to 1998/99, at the address of Taxation and Financial Services Limited, its tax representative.

5. There is a management service agreement dated 1 November 1990 made between the Taxpayer and Company B ('the Service Agreement') whereby, inter alia, Company B agreed as from 1 November 1990 at a monthly management fee of $40,000 to provide the Taxpayer with consultancy, technical, managerial, organization, administrative and financial services; all necessary offices, office plant, machinery, furniture and equipment and other premises and fixtures and fittings including domestic accommodation for employees engaged pursuant to the agreement; to engage all employees as necessary for the Taxpayer's business; to purchase or procure foods, supplies and services necessary for the Taxpayer's business including the provision of motor vehicles, library, legal wearing apparel, telephones, telex machines, stationery, postages and advertising; and to be responsible for all entertainment and travelling expenses necessary for the Taxpayer's business and all management expenses and outgoings in respect of premises owned or leased by the Taxpayer, and the Taxpayer was entitled to receive from Company B monthly financial reports and have access to its book and accounting records in relation to the services provided as to verify the amounts for which Company B invoiced him. There was also a term that the agreement should not be amended, supplemented or modified except by a written instrument signed by both parties. The Service Agreement was signed by the Taxpayer and Ms E on behalf of Company B.

6. There is also an employment agreement dated 1 November 1990 made between Company B and the Taxpayer ('the Employment Agreement') whereby Company B appointed the Taxpayer as its managing director for a term of five years commencing on 1 November 1990 until 31 October 1995, which should continue until it was terminated by either party giving to the other party three months' notice in writing. Under the Employment Agreement, the Taxpayer agreed to undertake such duties and exercise such powers in relation to Company B and its business as the board should from time to time assign to him and Company B agreed to pay the Taxpayer a salary to be agreed by them from time to time; to provide the Taxpayer with rent-free furnished living accommodation, a motor car and a driver; to pay the joining fees and expenses including monthly bills at any three clubs nominated by the Taxpayer; to pay all medical expenses, premiums to a provident fund, professional subscriptions, education fees of the Taxpayer or family, premiums on any insurance policies of the Taxpayer or family; to pay or reimburse the Taxpayer all reasonable travelling and entertainment expenses incurred in the course of the company's business and all monthly subscriptions to clubs with food and drink items in club bills, and to provide the Taxpayer each year a first class air passage Hong Kong/London/Hong Kong. This Employment Agreement was also signed by the Taxpayer and Ms E on behalf of Company B.

7. In the accounts of his legal practice, the Taxpayer recorded the following income and expenditures:

| **Year ended 31 March** | **1995** | **1996** | **1997** | **1998** | **1999** |
|---|---|---|---|---|---|
| | $ | $ | $ | $ | $ |
| Fee income | 2,959,500 | 5,609,100 | 5,069,460 | 6,472,855 | 5,886,550 |
| Accountancy fee | 3,300 | 3,500 | 4,100 | 4,500 | 4,500 |
| Business registration | 2,250 | 2,250 | 2,250 | 2,250 | 2,250 |
| Practising certificate | 1,000 | 1,000 | 1,000 | 1,100 | 1,300 |
| Management fee | 1,610,130 | 1,886,481 | 1,897,210 | 2,463,028 | 2,276,604 |
| Bar subscriptions | 3,100 | 4,100 | 4,100 | 5,280 | 5,810 |
| Professional indemnity insurance | - | - | 2,375 | 1,900 | 1,570 |
| Court clothes | - | - | - | 8,700 | 2,560 |
| | 1,619,780 | 1,897,331 | 1,911,035 | 2,486,758 | 2,294,594 |
| Net profit | 1,339,720 | 3,711,769 | 3,158,425 | 3,986,097 | 3,591,956 |

8. In his individual tax returns, the Taxpayer declared the net profits as referred to in paragraph 7 above as the assessable profits he derived from his legal practice but he did not declare that he had received any salary.

9. While the assessor was making enquiries, he raised on the Taxpayer profits tax assessments for the years of assessment 1994/95 to 1998/99 according to the assessable profits declared in the Taxpayer's individual tax returns.

10. The Taxpayer did not object against the profits tax assessments for the years of assessment 1994/95 to 1998/99 raised on him.

11. In the profits and loss accounts of Company B, the following particulars were recorded:

| **Year ended 31 March** | **1995** | **1996** | **1997** |
|---|---|---|---|
| | $ | $ | $ |
| Income | | | |
| Management fee | 1,610,130 | 1,886,481 | 1,897,210 |
| Other income | - | 1,135 | 1,215 |
| | 1,610,130 | 1,887,616 | 1,898,425 |
| Expenses | | | |
| Chambers expenses | 164,693 | 187,063 | 190,000 |

| | | | |
|---|---|---|---|
| Directors' quarters expenses | 425,338 | 413,343 | 432,841 |
| Directors' allowances | 204,928 | 206,111 | 226,093 |
| Entertainment | 363,235 | 577,242 | 608,918 |
| Motor vehicle expenses | 65,234 | 53,618 | 40,543 |
| Legal and professional fees | 16,897 | 18,501 | 17,800 |
| Repairs and maintenance | 24,800 | 28,242 | 7,565 |
| Travelling | 83,240 | 149,297 | 127,412 |
| Insurance | 5,525 | 2,422 | 4,071 |
| Audit fee | 12,600 | 13,500 | 15,900 |
| Business registration | - | 2,250 | 2,250 |
| Bank charges and interest | 2,585 | 3,098 | 4,688 |
| Periodicals | 8,004 | 2,629 | 945 |
| Printing and stationery | 1,976 | 10,295 | 6,524 |
| Subscriptions | 2,172 | 250 | 4,446 |
| Telephone | 40,039 | 55,253 | 47,243 |
| Medical expenses | 26,090 | 14,061 | - |
| Donations | 1,000 | 2,400 | - |
| Sundry expenses | 1,210 | 5,145 | 31,415 |
| Depreciation | 83,891 | 51,929 | 38,214 |
| | 1,533,457 | 1,796,649 | 1,806,868 |
| Profit before taxation | 76,673 | 90,967 | 91,557 |

| **Year ended 31 March** | **1998** | **1999** |
|---|---|---|
| | $ | $ |
| Income | | |
| Management fee | 2,463,028 | 2,276,604 |
| Other income | 1,697 | 1,694 |
| | 2,464,725 | 2,278,298 |
| Expenses | | |
| Chambers expenses | 274,000 | 314,839 |
| Directors' quarters expenses | 522,734 | 533,934 |
| Directors' salaries | 90,900 | 98,000 |
| Entertainment | 981,382 | 1,172,730 |
| Motor vehicle expenses | 63,938 | 85,987 |
| Legal and professional fees | 20,657 | 19,610 |

| | | |
|---|---|---|
| Repairs and maintenance | 26,793 | 46,920 |
| Travelling | 241,927 | 146,883 |
| Audit fee | 17,500 | 17,500 |
| Business registration | 2,250 | 2,250 |
| Bank charges and interest | 8,507 | 11,971 |
| Periodicals | 3,120 | 3,620 |
| Printing and stationery | 6,036 | 6,128 |
| Telephone | 38,880 | 36,964 |
| Sundry expenses | 9,614 | 11,163 |
| Depreciation | 37,503 | 24,452 |
| | 2,345,741 | 2,552,951 |
| (Loss)/Profit before taxation | 118,984 | (274,653) |

12. Having taken into account of the costs of the management services provided by Company B to the Taxpayer, the Commissioner revised the assessments of the Taxpayer for the years of assessment 1994/95, 1995/96, 1996/97, 1997/98 and 1998/99. In respect of the respective amounts of management fee claimed to have been paid by the Taxpayer in those years of assessment, the Commissioner only allowed the amounts of chambers expenses, legal and professional fee, printing and stationery and periodicals expenses and depreciation on computer and one-half of the amounts of motor vehicle expenses, telephone charges, and depreciation on motor vehicle as appeared in the profits and loss accounts of Company B in those years of assessment, plus a mark-up of 12.5 per cent.

13. During the course of investigation, the Taxpayer's tax representatives provided the assessor with, inter alia, the following information:

(a) 'The nature of the services is the provision of administrative and supporting services to our client. Such services include such assistance, outgoings and expenses arising thereon that a barrister would normally encounter.'

(b) 'The amount of fees were calculated as five percent on all expenses and outgoings incurred by [Company B] in providing the requisite services.'

(c) 'The services in question are provided in order to allow [the Taxpayer] to concentrate his attention on the discharge of his professional duties ...'

(d) 'Due to legal restrictions imposed on the profession, members are required to make use of a "service company" for promoting their practice business and the provision of requisite facilities of their profession. Therefore, the structure is

intended to put the professional person on a level standing with a sole proprietor in other areas of commerce using a corporate structure.'

(e) '... [the Taxpayer] is not only a barrister but an employee of the company. The so-called "private expenses" are in fact fringe benefits provided by the company to him in his capacity as a director of the company. From the company's point of view, they are deductible expenses under Section 16(1) of the Inland Revenue Ordinance, with which your department should have no dispute. Following [the Taxpayer's] practice, the management fees should also be deductible in full as:

1. The management fees were incurred for services provided to the practice;

2. The management fees are as agreed by both parties, which are considered as separate legal entities. The management company also requires the services of [the Taxpayer] in order to discharge the obligations set out under the terms of the management agreement.'

(f) A breakdown of the chamber expenses. [Appendix E attached to the determination of the Commissioner (a copy herewith)].

(g) A breakdown of the remuneration accrued to the staff of Company B. [Appendix F attached to the determination of the Commissioner (a copy herewith)].

(h) Copies of the cash book of Company B for the years of assessment 1994/95 to 1998/99. [Appendices G to G4 attached to the determination of the Commissioner].

**The determination of the Commissioner of 31 July 2000**

14. In the determination, the Commissioner held that the question to decide was whether the management fees were deductible expenditures in law when computing the chargeable profits of the Taxpayer's legal practice and that this question must be answered objectively. The Commissioner was of the view that the two agreements between the Taxpayer and Company B did not preclude him from examining whether the management fees were deductible expenditures incurred in the production of profits.

15. The Commissioner did not accept that the management fees were no more than ordinary business expenditures because the Taxpayer's management fees far exceeded his chamber expenses. There was also no evidence that valuable services were provided by Company B which justified the huge sums of management fees. The lack of a rational basis upon which the management fees were charged suggested that the sums were arbitrary, lacking in commercial

reality and thus were not bona fide incurred in the production of profits. Furthermore, since most of the expenses charged in the accounts of Company B were private and domestic in nature and had little to do with the carrying on of any business, the Commissioner found that the management fees were not wholly incurred by the Taxpayer to produce chargeable profits and that they were not strictly incurred for the purpose of producing chargeable profits.

16. The Commissioner was also of the view that the transaction between the Taxpayer and Company B was artificial within the ambit of section 61 of the IRO.

17. Having looked into the seven matters set out in section 61A(1) of the IRO, the Commissioner concluded that the Taxpayer and Company B had entered into a transaction for the sole and dominant purpose of enabling the Taxpayer to obtain a tax benefit.

**The oral evidence before us**

18. The Taxpayer gave sworn testimony in support of his appeal. No witness was called. Ms E did not attend the hearing to give evidence.

19. The Taxpayer gave the following evidence in chief.

20. He came to Hong Kong to commence employment with the Hong Kong Government as a crown counsel in one of the divisions of the Attorney-General's Chambers. He was later admitted as a barrister in Hong Kong and commenced private practice.

21. He relied almost entirely on the administrative support of Company B to operate his legal practice. Since his chambers were shared by a number of barristers, he received limited services from it. For a variety of reasons, he remained a member of chambers in commercial premises but the most important reason of all was because Bar Code of Conduct forbid barristers to operate wholly from domestic premises. He had the largest room in the chambers with two computers, one for himself and the other for Company B's secretarial or administrative employee, his own printer and own law library. Because his works were always on an urgent basis, he required independent back-up professional and administrative facilities.

22. Company B through its employee, Ms E, who was his fellow director and shareholder, organized and administered the whole of his professional life as a barrister. Those services included banking, ordering of stationery, typing, preparation and dispatch of fee notes, collection of fees and signing of most cheques. He did not run Company B. Ms E essentially did. He was in effect the second director or shareholder required by law. It was wrong to say that Company B did not have premises. Company B's premises were within his room in the chambers and the Road F premises were an extension of his chambers.

23. The Road F premises were domestic premises with four bedrooms, a large workroom, a large sitting or reading area, a kitchen, a maid's room and three bathrooms. The workroom housed a computer, a printer, two book shelves, one for law books, one for files and a desk. It was utilized by him for his practice and for storage of records relating to this appeal. Because the workroom was cluttered and the reading light was better in the sitting room, he did most of his reading of files and preparation of cases in the sitting room. The facilities, such as telephone, fax machine, television and video recorder which were essential to his practice, were placed in the sitting room. His wife and two grown-up sons lived in Country G. He occupied the Road F premises alone with occasional visits by his family and friends from overseas. He used the Road F premises as his chambers.

24. He was a member and also a governor of the board of Club H of which many barristers, solicitors and business people were members. He regarded this club an important part of his client base. Similar considerations applied to Club I, Club J and Club K of which he was also a member.

25. Before the use of Company B, he had taken advice from his accountants on the operation of service companies which, he was given to understand, was acceptable to the Revenue. From the outset he had no intention to operate Company B as a sham or a way of re-circulating money for the purpose of obtaining a tax benefit. He used Company B so that he could devote his time totally on his professional duties.

26. The Taxpayer was cross-examined by Counsel for the Revenue, and he gave the following evidence in cross-examination.

27. When he was asked to confirm that the cash injections in Company B's accounts were provided by him, he responded that this question could only be answered by Ms E as she was the only person who administered Company B. He asserted that he played no part in the running of Company B.

28. The Taxpayer agreed that he could have employed Ms E as his personal assistant but he asserted that he was free to choose a way which would give him better tax benefits. He said that for the first few years when Ms E was helping out in Company B, she opted for and they jointly decided that she was to be remunerated indirectly and so she had the use of a supplementary credit card under the name of Company B and also his club bills but he never monitored the extent to which she used them. Ms E received a salary for two subsequent years of assessment. He conceded that Ms E was remunerated indirectly only with his consent and by his direction.

29. He explained that the Road F premises and the motor car were both taken under the name of Company B so as to take advantage of an incorporation's limited liability. He agreed that the Road F premises were domestic premises but he asserted that he used two designated areas in the premises as an extension of his chambers. It was put to the Taxpayer that the totality of the

expenses of the Road F premises and the cost of the maid were included in the accounts of Company B as expenses by reason of the Employment Agreement and that these expenses were not claimed by the Taxpayer as deductible expenses by reason of the Road F premises being an extension of his chambers. The Taxpayer replied that the Employment Agreement was set up in 1990 and it was his understanding that it complied with the requirements of the then Commissioner of Inland Revenue.

30. The Taxpayer was questioned on the entries in Company B's ledger. There were regular payments to 'L' which the Taxpayer explained were the monthly costs for maintaining a pleasure junk. The Taxpayer claimed that those costs were entered as entertainment expenses because the junk was used for entertainment. He said that many judges, solicitors and barristers had been entertained on it. As to the Taxpayer's and Ms E's food bills with Supermarket M some of which were being entered as director's allowance and some as entertainment expenses, the Taxpayer conceded that some of the food bills might well be for his personal consumption but he asserted that some were for business purposes. As to all the Taxpayer's club bills and club monthly subscriptions being charged to Company B's accounts as entertainment expenses, he claimed that it was so because he used the clubs as his client base. It was pointed out to him that Ms E's credit card payments including expenses appeared to be of personal nature were booked through the Company B's accounts as entertainment expenses. He said that it was because Ms E was not paid a salary initially. It was also pointed out to him that some of his wife's expenses were booked as entertainment expenses and some under the director's account and that these expenses were not claimable under the Employment Agreement. But the Taxpayer argued that since Company B was a private company and he was one of the two shareholders and a beneficial owner, he was not strictly bound by the terms of the Employment Agreement or he could be flexible in the interpretation of the Employment Agreement. He conceded that he did not keep records to distinguish what he spent on a personal basis and what he spent for business purposes.

31. In the course of re-examination, the Taxpayer claimed that the entertainment expenses had been adjusted downward to take into account of the personal element of those expenses. When questioned on the basis upon which the adjustments were made, he explained that his accountants advised him that not every item of the entertainment expenses was justifiable as a deduction but from certain guidelines of the Revenue and other cases dealt with by them, they knew what the Commissioner would accept as reasonable and the adjustments were made by his accountants on that basis.

**The Taxpayer's submissions**

32. Counsel for the Taxpayer submitted as follows.

33. The Taxpayer was a barrister in private practice who had made use of Company B since commencement of his practice in 1990 to provide administrative services. The Taxpayer was entitled to a deduction if the management fees were deductible expenses under section 16 of the

IRO. The test to apply was whether the management fees were incurred in the production of the Taxpayer's assessable profits. The test did not involve a minute examination of the expenses of Company B. The Taxpayer and Company B were separate legal entities. The subject of the appeal was the assessment of the Taxpayer and not those of Company B. Examination of expenses was only relevant if the payment of the management expenses to Company B and the two agreements with it were ignored.

34. Purpose must be considered in the light of all the relevant factors. Brennan J in Magna Alloys & Research Pty Ltd v FCT (1980) 80 ATC 4542. The purpose in section 16 was an objective one. The Taxpayer was entitled to a deduction if the management fees were 'money laid out in furtherance of a purpose of gaining income'. The objective purpose of using Company B was to obtain accommodation, computer services, secretarial back-up, administrative services and the organization of the Taxpayer's professional life as a barrister. Thus, the management fees were laid out in the production of profits.

35. This was not a case where the corporate veil could be drawn aside. The onus was on the Taxpayer to prove that the management fee was incurred in the production of his profits and the same was paid. But the onus turned when the Commissioner attempted to look through the corporate veil. The onus was on the Commissioner to show that a transaction was artificial or fictitious. CEC v Comptroller of Income Tax [1971] SLR Lexis 68 was referred.

36. The Taxpayer's Counsel also drew our attention to the following in relation to section 61A of the IRO.

37. The policy consideration behind the introduction of section 61A was that it would be applied only in those cases of 'blatant or contrived tax avoidance arrangements' but that it 'should not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs.'

38. This statement was said to be 'a fair summary of the intention behind the convoluted provisions in section 61A' in D20/92, IRBRD, vol 7, 166 at 185. The statement was consistent with the words of Lord Diplock in Europa Oil (NZ) Limited v Commissioner of Inland Revenue (No 2) [1976] 1 WLR 464:

> '*The section [section 108 of the New Zealand Land and Income Tax Act 1954] does not strike down ordinary business or commercial transactions which incidentally result in some saving of tax. They will not be struck down if the method chosen for carrying them out involves the payment of less tax than would be payable if another method was followed. In such case avoidance of tax will be incidental to and not the main purpose of the transaction or transactions which will be the achievement of some business or commercial object;*' at 475 F to H.

39. A taxpayer had the right, where there was more than one way to structure his affairs, to choose the more tax efficient manner. Mangin v Inland Revenue Commissioners [1971] AC 739:

> '*if a bona fide business transaction can be carried through in two ways, one involving less liability to tax than the other, their Lordships do not think that [an anti-avoidance provision] can properly be invoked to declare the transaction wholly or partly void merely because the way involving less tax is chosen.*' at 751 D to E.

40. The seven matters referred to in section 61A must be considered objectively and globally. The sole and dominant purpose of the arrangement between the Taxpayer and Company B was for the provision of services. There was also the advantage of obtaining limited liability.

41. The definition of 'tax benefit' in section 61A(3) predicated that there must either be: (a) some pre-existing liability to tax which was being avoided; or (b) some pre-existing circumstances which, if continued undisturbed in the normal course, would give rise to, or might reasonably be expected to give rise to a liability to pay tax – which was being avoided. Neither of these situations applied since the arrangement had been in place from the commencement of the Taxpayer's practice. Thus, there was no room for the application of section 61A in the present case.

42. Where section 61A bit, there would be no scope for the operation of section 61, since it was predicated on the contradictory assumption that a 'sham' could have fiscal effect. The transaction between the parties was not a sham because the parties intended to be legally bound by the agreements and there were commercial benefits to each party by the arrangement.

**The Revenue's submissions**

43. The issue in this appeal was one of fact. The issue was whether the management fee claimed as an expense by the Taxpayer was properly deductible for the purpose of ascertaining his net profit before assessment to tax. Since the amount of the management fee was calculated by reference to the accumulated expenses incurred by Company B, the fee might be broken down into its component parts and only those expenses which were incurred in the production of the Taxpayer's profits and were not excluded under section 17 should be deductible for the purpose of an assessment to tax.

44. It was not the Revenue's case that a barrister could not deploy the medium of a genuine service company as a tax efficient organization of his business. The actual issue was whether the Taxpayer's use of Company B was commercially genuine, or whether it was an arrangement which did no more than predominantly provide the Taxpayer with a tax benefit. In this respect, an inquiry by the Board into the terms and effect of the Service Agreement, the Employment Agreement, and

how they were implemented, and what effects were achieved, was incontrovertibly a requisite exercise to the determination.

45. The onus of proof was on the Taxpayer to establish that his arrangement with Company B was a genuine commercial arrangement. The Taxpayer's authority CEC v Comptroller of Income Tax supported the contention. As the instant matter was not 'an investigation case' but an assertion by way of appeal against the Commissioner's determination that the tax levied was excessive, thus, section 68(4) of the IRO applied.

46. The Service Agreement and the Employment Agreement taken together were artificial within the meaning of section 61 in that the Taxpayer as a managing director of Company B received substantial benefits in respect of duties and powers which he never exercised; the agreements lacked commercial reality; the management fee was calculated by reference not to the facilities or services provided by Company B but was geared to the expenses charged by the Taxpayer to Company B; under the Service Agreement Company B was to be paid $40,000 per month but instead it was paid 5% mark-up on the expenses charged notwithstanding the absence of such charging provision in the Service Agreement; and Company B was also paying expenses to which the Taxpayer was not entitled and not only that the two agreements lacked commercial reality, the implementation of which demonstrated the true purpose was no more than to provide the Taxpayer with a tax benefit he would not otherwise have enjoyed.

47. In determining whether section 61A of the IRO had any application to this appeal, that the Commissioner's approach in his determination was right and that the two agreements taken together had the effect of conferring a tax benefit on the Taxpayer was an incontrovertible proposition.

**The statutory provisions**

48. The deduction of outgoings and expenses is governed by section 16(1) of the IRO.

> *' 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 ...'*

49. However, section 17(1) restricts the deduction of certain outgoings and expenses.

> *' 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; and*
>
> *...*
>
> *(b) subject to section 16AA, any disbursements or expenses not being money expended for the purpose of producing such profits;*
>
> *...*
>
> *(f) rent of, or expenses in connection with, any premises or part of premises not occupied or used for the purpose of producing such profits;'*

50. Furthermore, section 61 provides that if a transaction is found to be artificial or fictitious, the transaction may be disregarded.

> *' 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.'*

51. Section 61A deals with transactions designed to avoid liability for tax.

52. Section 68(4) of the IRO states the onus of proof in the assessment:

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

**Our findings**

53. Whether an expense is an allowable expense is governed by sections 16 and 17 of the IRO. Section 16(1) 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 of the year of assessment in question. Section 17 disallows deduction of certain types of outgoings and expenses. If a taxpayer fails to prove that an expense was incurred for the production of his assessable profits, the whole of that expense will be disallowed. In the present case, if the Taxpayer is unable to prove that the management fees were incurred in the production of his assessable profits, the whole of these management fees would be disallowed. But if an expense is capable of analysis and subdivision or where section 61 or section

61A applies which allows dissection of the expenses, then that expense can be allowed 'to the extent' that it was incurred to produce the taxable profits and the balance thereof be disallowed. In the present case, since the management fees were made up of those expenses as detailed in Company B's profits and loss accounts plus a mark-up of 5%, they are thus capable of analysis and subdivision. Accordingly, only those expenses which are proved to be incurred in production of the Taxpayer's assessable profits would qualify as allowable deductions.

54. It is the Taxpayer's case that if he could establish that the management fees were incurred for the purpose of gaining income, the management fees would qualify as allowable deductions. It was contended that since the management fees were incurred by the Taxpayer for the purpose of obtaining accommodation, secretarial and administrative support for his practice, the fees were laid out in production of assessable profits and were deductible expenses. Counsel for the Taxpayer argued that in the process of determining whether the management fees were deductible expenses, minute examination of Company B's expenses was inappropriate because we were concerned with the assessments of the Taxpayer and not those of Company B and that the issue was the purpose of the payment to Company B and not the purpose of the deductions claimed by Company B. He said that an attempt to examine Company B's expenses would amount to the lifting of the corporate veil. He argued that once the Taxpayer had established that there was an arrangement between him and Company B and the arrangement was acted upon, the onus was on the Revenue to show that it was artificial.

55. Counsel for the Revenue, on the other hand, argued that what under review here was the transaction and the transaction was the Service Agreement and the Employment Agreement which gave rise to the management fees, and in investigating how the transaction was implemented and how it was applied in practice, there involved a minute examination of Company B's expenses, including not only Company B's accounts but also the vouchers that made up the ledger entries.

56. We were asked by Counsel for the Taxpayer to decide on the question of whether a minute examination of Company B's expenses was permissible under the circumstances. We decide that we should allow an examination of Company B's expenses in detail. The amounts of management fees were calculated by reference to all the expenses and outgoings incurred by Company B in providing the requisite services plus a mark-up of 5%. Examination of those expenses and outgoings is necessary as to determine whether they were incurred in production of the Taxpayer's assessable profits. In so doing, we are not lifting the corporate veil nor are we saying that the Taxpayer is not free to decide his own affairs but the question of whether an expense is deductible in law when computing the chargeable profits must be answered objectively. We must look into the purpose of the payments and see whether the expense was bona fide incurred in production of the chargeable profits. The onus is on the Taxpayer to show that each of those items of expenses in Company B's profits and loss accounts was bona fide incurred for the production of his assessable profits. We are not persuaded by Counsel for the Taxpayer that since Company B's tax position was not in dispute, the expenses in Company B's accounts were the least relevant. Nor do we accept the contention that once the Taxpayer could establish that the management fees

were incurred for the purpose of acquiring professional services from Company B, the management fees should be allowed in full. The matter does not stop there. The Taxpayer is still required to prove that the expenses were bona fide incurred for production of his assessable profits.

57. Counsel for the Taxpayer argued firstly that the whole of the management fees should be allowed and secondly if the Board found that the transaction between the Taxpayer and Company B should be disregarded, the entertainment expenses should be allowed against the Taxpayer's professional income as well as the quarters expenses since the quarters were used for professional purposes. In the assessment stage, the Commissioner had considered the various items of expenditure in Company B's accounts and had allowed for deduction those items which reflected the costs attributable to the operation of the Taxpayer's practice. Those items were referred to in paragraph 12 above. We do not intend to disturb these deductions. As for the remaining items, the Taxpayer is required to prove their deductibility.

58. The Taxpayer adduced evidence at the hearing on how he used the Road F premises as an extension of his chambers. He explained the extent of his use of the club facilities for the purpose of entertainment. He did not adduce evidence on how the other items of expenditure as appeared in Company B's accounts were incurred. He told us that Ms E was in total charge of the operation of Company B so that he was free to concentrate on his legal practice. Ms E was a de facto personal assistant who provided him with secretarial or administrative services for his practice and solely ran Company B. He admitted that he played no part in the preparation of the accounts of Company B and indeed he did not keep records to distinguish entertainment expenses on a personal basis from those for business purposes. He explained that the operation expenses of the pleasure junk was booked as entertainment expenses because he used it for entertaining judges and lawyers. All club subscriptions and bills were also booked as entertainment expenses because he used the clubs as his client base. However, we do not accept that entertaining judges and fellow barristers and the use of the clubs were in production of the Taxpayer's income. The Taxpayer is a barrister and by Bar Code of Conduct he is not allowed to tout for business. Entertainment expenses to the extent now claimed are inconsistent with such code of conduct for barristers. We cannot accept the expenses incurred by Ms E and booked as entertainment expenses in Company B's accounts were expenses for production of the Taxpayer's assessable profits. Also, Ms E who exclusively ran Company B and dealt with the accounting matters did not give evidence. Thus, we have no way of understanding how Company B's accounts were kept, how the expenses were booked as entertainment expenses or director's allowances and how a distinction was drawn between expenses on a personal basis and expenses for business purposes. It follows that on the basis of the documentary and oral evidence before us, we are unable to find that the entertainment expenses as appeared in Company B's accounts were incurred for producing the Taxpayer's chargeable profits. In reaching this decision, we are also conscious of the adjustments which were said to have been made to the entertainment expenses. The adjustments were said to have been made by way of discounting certain percentages of the total entertaining expenses which represented the expenses of personal nature. Since no witness was called to give evidence as to what adjustments and how the adjustments were made or how the percentages were arrived at, we

cannot accept that the amounts of entertainment expenses now appeared in Company B's accounts represented only those expenses for business purposes. Even if we had evidence in this regard, we would have grave doubt as to the accuracy of the adjustments since the Taxpayer gave evidence that he kept no record of nor did he draw distinction between entertainment expenses for personal or business purposes. The adjustments could not be anything but arbitrary. Thus, we cannot accept the adjustments as proof that the items of entertainment expenses as now appeared in Company B's accounts were incurred by the Taxpayer for business purposes.

59. Having disposed of the entertainment expenses, we now come to the other item of expenses on which the Taxpayer gave evidence, the directors' quarters expenses. Looking at the breakdown of the remuneration accrued to the staff of Company B which was supplied by the Taxpayer's tax representatives to the assessor and referred to in paragraph 13(g) above, it appears that only those directors' quarters expenses in the years of assessment 1994/95 and 1995/96 were incurred in respect of the Taxpayer's quarters while those in the remaining years of assessment 1996/97, 1997/98 and 1998/99 were incurred in respect of Ms E's quarters. Since no claim was made that Ms E's quarters were used for production of the Taxpayer's income, we are thus only concerned with the expenses of the Taxpayer's quarters.

60. We have been referred by Counsel for the Revenue to the case of Anthony Patrick Fahy v CIR 3 HKTC 695 where the medical expenses of a certified public accountant were disallowed as deductible expenses on the grounds that they were not incurred for the purpose of producing business profits. We quote the following passages by Godfrey J from the case.

> ' *But where the expenditure has a dual purpose, partly of a domestic or private nature, and partly for the purposes of the preservation of the Taxpayer of his own person as an asset to his business, to the extent that the expenditure is a domestic or private character, in my judgment it is not allowable.*
>
> *It seems to me that the appeal of the Taxpayer here must fail at this hurdle.*
>
> *In my judgment, the requirement for this operation was as much for domestic or private as it was for business purposes. I cannot believe (although I think at one stage the Taxpayer was inclined to suggest it) that the Taxpayer would not have had this operation at all but for the purpose of earning or continuing to earn the profits of his profession. Nor can I see any way of distinguishing between those elements of the purpose which are domestic and private and those which are business. It seems to me to be one indivisible matter; there cannot be any sensible apportionment.'*

The considerations in the case reflected the provisions of section 16(1) where outgoings and expenses can be deducted from assessable profits 'to the extent to which they are incurred ... in the

production of profits' and section 17(1)(a) and (b) which disallow domestic or private expenses and expenses not being expended for the purpose of producing such profits.

61. Although we are dealing with different types of expenses, directors' quarters expenses as opposed to medical expenses, they are similar in one aspect. Both expenses had a dual purpose, that of domestic and business. Thus, we derive assistance from the case of Anthony Patrick Fahy in reaching our decision on the deductibility of the quarters' expenses.

62. It is a matter of fact and degree whether an expense was incurred in production of assessable profits. In the present case, the Taxpayer had a largest room in the chambers for his legal practice. Ms E who assisted him in his practice had the use of his room in the chambers. All the facilities were there for his use though the Taxpayer said they were inadequate for his purpose. He had court appearances and use of the chamber for preparation of cases and meeting of clients during daytime. The Road F premises were residential premises used by the Taxpayer as his residence and by his family and overseas friends for occasional visits. As we see it, the Taxpayer must have a place of residence. The rent and rates of the Road F premises and indeed the costs of the maid which were included in the quarters' expenses must be incurred whether or not the Taxpayer used the premises for work purposes. We are of the view that the Taxpayer's works were carried out predominantly at his chamber. The use of the Road F premises for work purposes was only incidental. Under the circumstances, we find that the quarters' expenses were not incurred in the production of the Taxpayer's income. The quarters' expenses being 'domestic or private expenses' were also non-deductible under section 17(1)(a). Thus, we find that the directors' quarters expenses are not deductible expenses under the law.

63. The Taxpayer did not adduce evidence nor was there documentary evidence to substantiate that the remaining items of expenditure as appeared in Company B's accounts were incurred in production of the Taxpayer's income. Thus, those remaining items must also fail as deductible expenses under section 16(1) of the IRO.

64. We have disposed of the appeal without having to consider section 61 or section 61A of the IRO. Had it been necessary for us to do so, we would take the view that the transaction between the Taxpayer and Company B arising out of the Service Agreement and the Employment Agreement was artificial within the ambit of section 61.

65. Briefly, we find the transaction artificial for the following reasons. The Taxpayer engaged the service of Company B in order that he could fully devote his time to his legal practice and yet he entered into the Employment Agreement to provide services from time to time assigned to him by Company B. The proposed provision of services by the Taxpayer is inconsistent with the reason for the Taxpayer to engage Company B's services. The terms of the Employment Agreement which effectively took care of all the Taxpayer's living expenses without limits being set and without the services required from the Taxpayer being stipulated are commercially unrealistic. The Taxpayer gave evidence that he was never required to perform any services for Company B

apart from being the second director required by law, and yet Company B provided the Taxpayer with all kinds of benefits. Ms E who was said to be engaged to provide the necessary services to the Taxpayer, on the other hand, was not required to enter into an employment agreement with Company B and the fact that she was not paid a salary initially but was remunerated indirectly by the use of Company B's credit card and the Taxpayer's club facilities were commercially unrealistic. In the Service Agreement, it was a term that Company B was to be paid a monthly management fee of $40,000. This term was changed without a written agreement between the parties, notwithstanding that it was stipulated in the Service Agreement that any alteration to the terms of the Service Agreement must be in writing and signed by both parties. All these factors illustrate the artificiality of the transaction between the Taxpayer and Company B. We also endorse the views expressed by Counsel for the Revenue on the matter.

66. As to section 61A, we also accept the Commissioner's reasons in his determination to conclude that the Service Agreement and the Employment Agreement were entered into by the Taxpayer and Company B for the sole and dominant purpose of enabling the Taxpayer to obtain a tax benefit.

67. We note that the Taxpayer felt aggrieved that he was not given the same treatment as those of other barristers in similar situations. He said that some barristers were allowed as deductions their entertainment and quarters' expenses. We are of course in no position to comment on those cases, but the Taxpayer must realize that each case has its own particular facts and the law is that the onus is on the appellant to prove that the expenses were incurred for production of profits, failing which those expenses wholly or partly cannot be allowed.

68. For the aforesaid reasons, we dismiss the Taxpayer's appeal and confirm the 1994/95 (additional), 1994/95 (second additional), 1995/96 (additional), 1995/96 (second additional), 1996/97 (additional), 1996/97 (second additional), 1997/98 (additional) and 1998/99 (additional) profits fax raised on the Taxpayer.

Appendix E

File No. XXX/XXXXX/XXX

| **Year of assessment** | **Chamber's name and address** | **Rent** | **Chamber's staff expenses** | **Office expenses** | **Total** |
|---|---|---|---|---|---|
| 1994/95 | Chamber N<br>Address O | $145,000.00<br>($10,000 × 1 +<br>$12,000 × 10 +<br>$15,000 × 1) | $12,000.00 | $7,693.09 | $164,693.09 |
| 1995/96 | As above | $180,000.00<br>($15,000 × 12) | $6,000.00 | $1,063.19 | $187,063.19 |
| 1996/97 | As above | $180,000.00<br>($15,000 × 12) | $10,000.00 | $- | $190,000.00 |
| 1997/98 | Chamber P<br>Address Q | $249,000.00<br>($15,000 × 4 +<br>$23,000 × 6 +<br>$25,000 × 2) | $10,000.00 | $15,000.00 | $274,000.00 |
| 1998/99 | As above | $306,000.00<br>($25,500 × 12) | $8,250.00 | $589.00 | $314,839.00 |

Appendix F

Staff remuneration
(File No. XXX/XXXXX/XXX)

| | **[Mr A]** | **[Ms E]** | **Total** |
|---|---|---|---|
| | HK$ | HK$ | HK$ |
| **Year ended 31st March, 1995** | | | |
| Directors' quarters expenses | 425,338.00 | - | 425,338.00 |
| Directors' allowances | | | |
| - College fee | 66,750.00 | - | 66,750.00 |
| - Court clothes | 13,760.00 | - | 13,760.00 |
| - Language fee | - | 4,227.00 | 4,227.00 |
| - [Supermarket M] | - | 120,191.00 | 120,191.00 |
| | 80,510.00 | 124,418.00 | 204,928.00 |
| **Year ended 31st March, 1996** | | | |
| Directors' quarters expenses | 413,343.00 | - | 413,343.00 |
| Directors' allowances | | | |
| - Maid salaries | - | 50,600.00 | 50,600.00 |
| - College fee | 55,954.00 | - | 55,954.00 |
| - Language fee | - | 7,840.00 | 7,840.00 |
| - [Supermarket M] | - | 91,717.00 | 91,717.00 |
| | 55,954.00 | 150,157.00 | 206,111.00 |
| **Year ended 31st March, 1997** | | | |
| Directors' quarters expenses | - | 432,841.00 | 432,841.00 |
| Directors' allowances | | | |
| - Maid salaries | - | 48,000.00 | 48,000.00 |
| - College fee | 148,493.00 | - | 148,493.00 |
| - [Supermarket M] | - | 29,600.00 | 29,600.00 |
| | 148,493.00 | 77,600.00 | 226,093.00 |