

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D17/99

Profits Tax – deductible expense – management fee accountable to service company – section 16 and 68(9) of the Inland Revenue Ordinance.

Panel: Benjamin Yu SC (chairman), Colin Cohen and Robert Kwok Chin Kung.

Date of hearing: 6 May 1999.

Date of decision: 31 May 1999.

The taxpayer was an accountant. He carried out the practice of a certified public accountant (the 'firm'). He was also a director and major shareholder of Company D. It was the taxpayer's case that Company D provided management services to his firm and he claimed that a sum of \$570,000 as management fee was accountable to Company D. It was not in dispute that the taxpayer never actually paid the management fee to Company D. The Commissioner disallowed the claim for deduction.

Held:

- (1) It would be common practice for documents such as management agreement, minutes of meeting, invoices and other contemporaneous records to be produced as evidence of an agreement or arrangement intended to have legal effect.
- (2) In order to be entitled to claim deduction under section 16(1) of the IRO, the taxpayer has to establish that:
 - (a) he had incurred the expense,
 - (b) it was incurred during the basis period, and
 - (c) it was incurred in the production of the income.
- (3) The appeal was completely devoid of merits. The power under section 68(9) of the IRO was exercised and the taxpayer was ordered to pay the costs of the appeal in the sum of \$5,000.

Appeal dismissed.

Doris Lee for the Commissioner of Inland Revenue.

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Taxpayer in person.

Decision:

1. The Taxpayers, Mr A and Ms B, are husband and wife. Mr A is an accountant and has been carrying on the practice of a certified public accountant ('Company C'). At the material time, Mr A was also a director and major shareholder of Company D. Company D was owned by him beneficially.

2. Mr A commenced his practice in 1991, but then only on a part time basis. According to him, he started full practice in August 1994. Some time before then, Mr A had set up Company D.

3. Since about 1994 and also during the relevant year of assessment, Company D had been carrying on the following activities:

- (1) the provision of company secretarial services for clients, including the incorporation of companies,
- (2) the provision of audit training for another accounting firm, and
- (3) the provision of recruitment consultancy services for clients.

It is Mr A's case that Company D also provided management services to his firm. There was, however, no management agreement in writing between Mr A and Company D. Mr A has not produced any minutes of meeting of Company D recording any management agreement that it had entered into with Mr A himself. Nor did Company D issue any debit note to Mr A for management fees.

4. Company C provided auditing, taxation and accounting services. During all material times, Company C and Company D shared the same offices and staff.

5. This appeal relates to the personal assessment on the Taxpayers for the year of assessment 1996/97 ('the relevant year of assessment'). In their return for that year, the Taxpayers elected personal assessment and had claimed a deduction for a loss of \$633,525 sustained in Company C. To arrive at that loss, Mr A had included a sum of \$570,000 as management fee ('the Sum') which Mr A claimed to be accountable to Company D. The assessor had disallowed the claim for deduction of the Sum, and the Commissioner had confirmed the personal assessment.

6. The Taxpayers appeal against the determination. The central issue in the appeal is whether the claim for deduction of the Sum should have been allowed. It is not in dispute that Mr A never actually *paid* the Sum to Company D. Indeed, Company D had been struck

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off by the Companies Registry in May 1996 for failure to file annual returns. Mr A's case is that the Sum of \$570,000 was the amount that his firm should account back to Company D as a proper adjustment of the over-allocation of expenses to Company D in the two previous years of assessment. Thus, in order to understand the nature of the deduction claimed and to assess its validity, we need to go slightly back in time – to the two previous years of assessment.

Year of assessment 1994/95

7. The audited accounts of Company D for the period from 1 February 1994 (date of incorporation) to 31 March 1995 showed a total turnover of \$125,855. This represented in fact the total income of Company D during that period from its business in audit training and recruitment consultancy. During that year of assessment, Company C recorded a total income of only \$16,500.

8. The expenses for Company D shown in its accounts included rental, staff salaries, charges for electricity and telephone, etc. We need not go into the details. But, on the evidence, this was half of the total expenditure for accommodation, staff salaries, utility charges and other expenses actually incurred by Company C and Company D together. Mr A emphasized to us that he had really treated Company D and his firm as one and the same.

9. The auditor's report for Company D's account for this period stated that:

‘An audit ... includes an assessment of the significant estimates and judgment made by the directors in the preparation of the financial statements.’

In other words, Mr A, as the director of Company D, had at some stage, made an estimate and judgment in terms of the proper apportionment of the expense attributable to his practice on the one hand, and Company D on the other for that period, and in doing so, had allocated half of the expense to his own firm and the other half to Company D.

10. There was no mention in the audited accounts of Company D of any management agreement entered into with Mr A. On the contrary, the directors' report contained the following statement:

‘No contracts of significance to which the Company was a party and in which a director of the Company had a material interest, whether directly or indirectly, subsisted at the end of the period or at any time during the period.’

Year of assessment 1995/96

11. For the financial year ended 31 March 1996, the audited accounts of Company D recorded a consultancy fee income of \$324,127. In that same year, Company C had an income of \$139,750. Again, Mr A allocated half of the expenses (including rental and salaries) to Company D and the other half to his firm. The audit report of Company D's

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account contained the same statement by the auditor quoted in paragraph 9 above. The directors' report contained the same statement quoted in paragraph 10 above.

Mr A's evidence

12. Mr A said that he was engrossed in his practice and attending to his clients in the first two years, and only addressed his mind on the proper allocation of the expenses some time after the end of the second financial year. He said he did not intend Company D to be remunerated (in the sense of making a profit) for providing management services to his practice; but only that it should be paying for its proper share of expenses. Mr A said that the staff spent only a very small amount of time on Company D's affairs. Mr A had produced to the Revenue a breakdown of the sum of \$570,000. This sum included rent and rates, staff salaries, depreciation on office equipment and furniture, electricity, stationery, telephone and paging, etc.

The Respondent's (the CIR's) submissions

13. Ms Lee submitted before us that since the Taxpayers' claim for deduction is made under section 16(1) of the **Inland Revenue Ordinance** ('the IRO'), they have to show that:

- (1) Mr A *incurred* the Sum in question;
- (2) he incurred the Sum *during the basis period* for the year of assessment 1996/97; and
- (3) he has incurred the Sum for *the production of chargeable profits*.

Ms Lee derived this submission from the wording of section 16 of the IRO, which reads:

'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 ...'

Ms Lee submitted that Mr A has shown none of these elements.

14. Ms Lee has also pointed to the absence of a written management agreement, the lack of any evidence of billing by Company D to Mr A's practice. She contended that the Sum was, at best, a gift given to Company D by Mr A, in order to utilize the tax losses available in Company D to reduce the Taxpayers' liability under personal assessment.

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Our findings

15. Having considered all relevant matters, we reject Mr A's evidence except where it is supported by documentary evidence.

16. We have grave doubt as to whether there was in fact a management agreement between Company D and Mr A. Mr A is and was a professional accountant, and must have been aware that it would be common practice for documents such as management agreement, minutes of meeting, invoices and other contemporaneous records to be produced as evidence of an agreement or arrangement intended to have legal effect. The fact that Company D had not charged Mr A any management fee in the years of assessment 1994/95 and 1995/96 again suggests to us that no management agreement existed. Further, Mr A, as a director of Company D, would have been guilty of making a false statement in his directors' report if there were in fact management agreement between him and the company as now contended.

17. We find that Mr A had, in the first two years, already given consideration to the proper allocation of expenses between Company D on the one hand and his firm on the other. We are unable to accept that there was any cause for re-allocation, and certainly none that we see to justify Company D being paid or credited with the Sum. In coming to this view, we have considered the fact that both Company C and the business of Company D would need to occupy office accommodation for the carrying on of the business; and both would have to engage the services of staff, consume electricity, and require the use of telephones and other office equipment or appliances, etc. to carry on their respective businesses. If the turnover of the two businesses were to be used as a guide, and we believe it can be, Company D may even have been under-charged in the last two years, and not other way round. In short, we wholly reject Mr A's evidence on this point.

18. It is relevant to note that in the year of assessment 1994/95, Company D had a loss of \$230,112 and in the year of assessment 1995/96, Company D recorded a loss of \$301,643; totalling \$531,755. If Mr A were to succeed in claiming deduction by notionally crediting the Sum to Company D, he would in effect be taking the benefit of the tax losses of Company D. We believe that it is not a coincidence that the two sums are of the same order, and we see a great deal of force in Ms Lee's submission that the Sum was in reality a gift by Company C to Company D with the view to utilizing the tax losses accumulated in Company D.

19. We also accept Ms Lee's submission on the need for the Taxpayers to establish:

- (1) that he had incurred the expense,
- (2) that it was incurred during the basis period, and

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- (3) that it was incurred in the production of the income, in order to be entitled to claim deduction under section 16(1) of the IRO. We agree with Ms Lee that the Taxpayers have not established these elements.

20. For all these reasons, we would dismiss the appeal and confirm the assessment.

21. We would further indicate that we take the view that the appeal is completely devoid of merits and we are inclined to exercise our power under section 68(9) of the IRO to order the Taxpayers to pay the costs of this appeal in the sum of \$5,000. But before doing so, we would give the Taxpayers an opportunity of making representation in writing to this Board as to why we should not so order. Any such representation should be furnished to the clerk of the Board within 21 days from the date of receipt of this decision. For this purpose, we adjourn the decision of this Board on the question of costs for further consideration.