

Case No. D18/05

Profits tax – whether or not the entire sum should be assessed or only 20% thereof should be charged – whether or not the sum was in the nature of a prepayment or deposit - sections 14(1),16(1) & 60 of the Inland Revenue Ordinance ('the IRO').

Panel: Jat Sew Tong SC (chairman), William Cheng Chuk Man and Winnie Lun Pong Hing.

Date of hearing: 16 March 2005.

Date of decision: 25 May 2005.

The taxpayer carried on an insurance agency business under the name of 'Company A' since 1995. By a contract entitled 'Letter of Understanding' ('LOU') dated 6 November 2001, the taxpayer was appointed as an insurance agent of Company B for a minimum of five years (but he did not commence services for Company B until 1 March 2002 when he registered with the Hong Kong Federation of Insurers). By a Letter of Undertaking dated 7 November 2001, the taxpayer was given, by way of loan, the sum of HK\$1,757,433 ('the Sum') on or about 9 November 2001 [comprising the 'Actual Signing Fee' of HK\$1,171,622 (ie an Initial Signing Fee of HK\$585,811 and the Balance of Signing Fee of HK\$585,811) and advance 'Monthly Bonus' of HK\$585,811], and that such 'loan' was repaid by setting off the 'Actual Signing Fee' and 'Monthly Bonus' for Year 1 paid or payable to the taxpayer pursuant to the LOU.

It was not in dispute that the taxpayer had satisfactorily completed his services with Company B for Year 1 starting from 1 March 2002 and remained an agent of Company B to date. No ground for repayment of any part of the Sum had arisen and no part of the Sum had been repaid to Company B by the taxpayer. As a result, the Commissioner originally determined that the Sum was consideration paid by Company B for the taxpayer services and received by him in the ordinary course of his trade or business during the assessment year 2002/03 and thus chargeable to profits tax for that year.

On appeal, the main contentions of the taxpayer were *inter alia* that the Sum was a 'Signing Fee' and that the Sum represented a deposit or prepayment of sums payable by Company B to him over the minimum contract period of five years; and therefore only a pro rata portion of it (being 20% for the relevant assessment year and each subsequent assessment year) should be chargeable for profits tax.

It was noted that at the date of hearing, both parties accepted the Board's (then provisional) view that the sum accrued or should be deemed to have accrued to the taxpayer by way of trading

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receipts arising in or derived from his trade or business on the following dates: HK\$585,811 (an Initial Signing Fee) on or about 1 March 2002; HK\$585,811 (the Balance of Signing Fee) on or about 28 February or 1 March 2003; HK\$585,811 (Monthly Bonus) from 31 March 2002 to 28 February 2003 at HK\$48,818 per month (disregarding the HK\$5 difference which was immaterial).

The issue before the Board was therefore whether or not the entirety of the Sum should be assessed to profits tax for the year of assessment 2002/03.

Held:

1. The Board was unable to accept the taxpayer's contention that the Sum was in the nature of a prepayment or deposit paid by Company B to the taxpayer. The Board rejected the taxpayer's construction of the relevant clauses (7-9) of the LOU that the entire Sum or portions thereof would be repayable by him in the event of his failure to meet the minimum business requirements under his contracts with Company B for any of the minimum 5-year term. Instead, the Board found that the clear terms of clauses 8 and 9 of the LOU indicated that the Sum would only be repayable by the taxpayer wholly or in part in the event of termination of the taxpayer's contracts with Company B during the five years. The taxpayer had not referred the Board to anything in the contracts signed by him with Company B which showed otherwise. Hence, any repayment obligation under the LOU was a contingent liability only; and the contingency had not arisen in this case [D85/03 (unpublished) followed].
2. The Board also rejected the case (concerning another agent of Company B who also apportioned the 'Initial Signing Fee' received from Company B into five years in the same way as the taxpayer did in this case and had not been challenged by the Commissioner) referred by the taxpayer in his response to the Commissioner's written submissions. The Board came to a view that it was not relevant for the determination of this appeal (since it was not a decision of this Board or a court decision) and, even if relevant, would not attach any weight to it. The Board's duty was to determine this appeal on what it considered to be the correct basis of the facts of this case as found by it. This Board was not concerned with whether the Commissioner's treatment of any other case was or may be wrong or inconsistent with what this Board considered to be the correct basis.
3. However, the Board differed from the Commissioner's Determination in relation to the 'Initial Signing Fee' of HK\$585,811 accrued or deemed to have accrued to the taxpayer on 1 March 2002 and the Monthly Bonus of HK\$28,818 accrued or deemed to have accrued to the taxpayer on 31 March 2002. These two sums did

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not accrue to the taxpayer during the assessment year 2002/03 but the previous assessment year. Accordingly, the Board varied the Determination so that the chargeable profits for the assessment year 2002/03 was reduced to HK\$1,122,804 (a deduction of HK\$634,629 which comprised the 'Initial Signing Fee' and 'Monthly Bonus' for March 2002 from the Sum); the remaining HK\$634,629 should be charged in the assessment year 2001/02 pursuant to section 60 of the IRO.

Appeal dismissed.

Case referred to:

D85/03 (unpublished)

Taxpayer in person.

Wong Ki Fong and Chan Siu Ying for the Commissioner of Inland Revenue.

Decision:

Introduction

1. In this appeal the Taxpayer objected to the profits tax assessment and personal assessment for the year of assessment 2002/03 raised on him.
2. The sole issue for determination of this appeal is whether a sum of HK\$1,757,433 received by the Appellant from 1 March 2002 to 1 March 2003 was chargeable for profits tax for the assessment year (as is contended by the Commissioner of Inland Revenue ('the Commissioner')), or whether only 20% thereof should be so charged (as contended by the Appellant).
3. At the end of the hearing on 16 March 2005, the Board adjourned the appeal to enable the Appellant to respond to the Commissioner's written submissions helpfully provided by representatives of the Commissioner at the hearing. It will be necessary to return to matters arising post-hearing at the end of this decision. Suffice it to say at this stage that the Board had considered all relevant materials before it, including the submissions and relevant materials supplied by the parties after the hearing, in coming to this decision.

Relevant facts

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4. The relevant facts (which are largely not in dispute) as found by the Board after taking into account all the documentary evidence and the oral evidence of the Appellant are as follows.

5. The Appellant carried on an insurance agency business under the name of ‘Company A’ since 1995.

6. By a contract entitled ‘Letter of Understanding’ dated 6 November 2001 (‘the LOU’) entered into between (inter alios) the Appellant and Company B, the Appellant agreed to remain an insurance agent of Company B for a minimum of five years. The LOU contained the following express terms:

- ‘3. Subject to Clause 8 and Clause 9 below, after the Applicant [ie the Appellant] has (i) signed the Contracts [as defined in the LOU], (ii) registered with the Hong Kong Federation of Insurers as an agent of the Company [ie Company B] and (iii) commenced services as an agent of the Company (the “Commencement Date”), the Company agrees to pay the Applicant an Initial Signing Fee based on proof of income provided by the Applicant, amounting to HONG KONG DOLLARS five hundred eighty five thousand and eight hundred and eleven only (HK\$585,811.00)...
4. The Applicant agrees to faithfully perform all obligations of the Contracts and to remain as a bona fide insurance agent of the Company for a minimum of 60 months from the Commencement Date.
6. (a) Subject to Clause 8 and Clause 9 below, the Company agrees to pay to the Applicant the Balance of Signing Fee for Year 1 at the end of the twelve (12) month period immediately after the Commencement Date provided that this amount does not exceed 100% of the Initial Signing Fee.
7. Subject to Clause 8 and Clause 9 below, the Company will pay the Applicant a Monthly Bonus in the sum of Hong Kong Dollars forty eight thousand and eight hundred and eighteen only (HK\$48,818.00) at the end of each month for a maximum period of 12 months subject to the Applicant’s meeting the following validation requirements in relation to the annualized first year premiums net after terminations for individual life and personal accident business written with the Company by the agency managed by and including the applicant at the end of the following dates (measured from the Commencement Date):

End of	1 st Quarter	2 nd Quarter	3 rd Quarter	4 th Quarter
Percentage of the Amount	20%	45%	70%	100%

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Payment of the Monthly bonus will cease immediately upon the Applicant's failure to meet the above validation requirement on a timely basis for any reason...

8. In the event that any of the Contracts is terminated for any reason by either the Applicant or the Company within twelve (12) months after the Commencement Date, the applicant agrees to refund to the Company (i) the whole of the Actual Signing Fee paid in Clause 3 and Clause 6 above, and (ii) all of the Monthly Bonus paid in Clause 7 above from the Commencement Date up to the date of termination, immediately and unconditionally.
9. In the event that any of the Contracts is terminated for any reason by either the Applicant or the Company within the period from the first (1st) year to fifth (5th) year after the Commencement Date, the Applicant agrees to refund part of the Monthly Bonus paid and Actual Signing Fee as defined below to the Company immediately and unconditionally, as follows:

<u>Termination of Contracts after the Commencement Date</u>	<u>Percentage of Monthly Bonus and actual Signing Fee to be refunded</u>
Within the 2 nd year	80%
Within the 3 rd year	60%
Within the 4 th year	40%
Within the 5 th year	20%

The Actual Signing Fee shall mean the sum of the Initial Signing Fee and the Balance of Signing Fee for Year 1 if any.'

7. There is no dispute that the Appellant was registered with the Hong Kong Federation of Insurers as an agent of Company B on 1 March 2002 and commenced services as an agent of Company B on that date.

8. It is not disputed that pursuant to a Letter of Undertaking dated 7 November 2001, the Appellant had received from Company B by way of loan the sum of HK\$1,757,433 on or about 9 November 2001 (comprising the 'Actual Signing Fee' of HK\$1,171,622 [HK\$585,811 under clause 3 and HK\$585,811 under clause 6(a) of the LOU] and advance 'Monthly Bonus' of HK\$585,811 [clause 7 of the LOU]), and that such loan was repaid by setting off the Actual Signing Fee and Monthly Bonus for Year 1 paid or payable to the Appellant pursuant to the LOU.

9. There is also no dispute that the Appellant satisfactorily completed his services with Company B for 'Year 1' starting on 1 March 2002, and remains an agent of Company B to date. No ground for repayment of any part of the sum of HK\$1,757,433 has arisen and to date no part of that sum has been repaid to Company B.

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10. Accordingly, the Board is of the view that the sum of HK\$1,757,433 accrued or should be deemed to have accrued to the Appellant by way of trading receipts arising in or derived from his trade or business on the following dates:

- 10.1. HK\$585,811 pursuant to clause 3 of the LOU on or about 1 March 2002;
- 10.2. HK\$585,811 pursuant to clause 6(a) of the LOU on or about 28 February or 1 March 2003 (for the purposes of this appeal it is immaterial whether it was 28 February or 1 March 2003); and
- 10.3. HK\$585,811 pursuant to clause 7 of the LOU from 31 March 2002 to 28 February 2003 at HK\$48,818 per month (disregarding the HK\$5 difference which is immaterial).

11. There is no dispute that the above sums are chargeable for profits tax. The issue is whether the entirety of the sums should be so charged for the assessment year 2002/03.

12. By a Determination dated 25 November 2004, the Deputy Commissioner of Inland Revenue determined that the entire sum of HK\$1,757,433 should be fully assessed to profits tax in the assessment year 2002/03. From that Determination the Appellant appeals to this Board.

The rival contentions

13. The Appellant claims that the entire HK\$1,757,433 was a ‘Signing Fee’ (see Appellant’s ‘TRADING AND PROFIT & LOSS ACCOUNT FOR THE YEAR ENDED MARCH 31 2003’ at Bundle B1/20-21), and that the whole sum represented a deposit or prepayment of sums payable by Company B to him over the minimum contract period of five years. It is contended that the sum represented ‘profits’ for the five years and therefore only a pro rata portion of it, being 20% for the relevant assessment year and each subsequent assessment year, should be chargeable for profits tax.

14. The Appellant’s contentions are, in essence, as follows. It is argued that pursuant to the LOU, he had to provide services to Company B for at least five years and that during that time, if he could not meet the minimum requirements imposed on him under the LOU, he had to repay the entire sum or portions thereof to Company B. It is further contended by the Appellant that he had to incur expenditure over the five years in order to earn the entire sum of HK\$1,757,433, so that it is only fair that tax should be charged on 20% of that sum for each of the five years and only if that portion of the sum is earned for that year.

15. The Commissioner originally contended that the sum of HK\$1,757,433 was consideration paid by Company B for the Appellant’s services and received by him in the ordinary

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course of his trade or business during the assessment year and thus chargeable to profits tax for that year. However, after being informed of the Board's (then provisional) view that the sum accrued or should be treated to have accrued to the Appellant in the manner stated in paragraph 10 above, the Commissioner did not dissent from that view. The Appellant also agreed with that view.

16. The Commissioner further accepted that on that basis, the original assessment would have to be varied so that the chargeable profits for the assessment year 2002/03 should be reduced to HK\$1,122,804 (HK\$1,757,433 – HK\$634,629 [the Initial Signing Fee of HK\$585,811 + Monthly Bonus for March 2002 HK\$48,818]). The remaining HK\$634,629 should be charged in the assessment year 2001/02 in accordance with section 60 of the Inland Revenue Ordinance ('IRO').

Determination

17. As stated above, the sole issue for determination on this appeal is whether the entire sum of HK\$1,757,433 accrued or deemed to have accrued to the Appellant from 1 March 2002 to 1 March 2003 was chargeable for profits tax for the assessment year, or whether only 20% thereof should be so charged.

18. Section 14 (1) of the IRO provides (in so far as material) as follows:

'... profits tax shall be chargeable for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business ...'

19. Section 16 (1) of the IRO provides (in so far as material) as follows:

'In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period ...' (emphasis added)

20. The Board is unable to accept the Appellant's contention that the sum of HK\$1,757,433 was in the nature of a prepayment or deposit paid by Company B to the Appellant.

20.1. Pursuant to the clear terms of clause 3 of the LOU, the Initial Signing Fee of HK\$585,811 was payable to the Appellant upon the fulfillment of the conditions stated in that clause, which took place on 1 March 2002.

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20.2. Further, the Balance of Signing Fee for Year 1 in the sum of HK\$585,811 was payable to the Appellant pursuant to clause 6(a) of the LOU at the end of the 12th month of his services with Company B which occurred on 28 February 2003 or 1 March 2003.

20.3. Moreover, the remaining sum of HK\$585,811 paid to the Appellant by way of Monthly Bonus did not form any part of the 'Initial Signing Fee' or 'Balance of Signing Fee for Year 1' as provided under clauses 3 and 6(a) of the LOU. It was the total sum payable to the Appellant under clause 7 of the LOU for the 12 months beginning 1 March 2002 (bar an immaterial difference of HK\$5) on account of the business he generated during that period.

21. The Board is unable to accept the Appellant's construction of clauses 7, 8 and 9 of the LOU that the entire HK\$1,757,433 or portions thereof would be repayable by him in the event of his failure to meet the minimum business requirements under his contracts with Company B for any of the minimum 5-year term.

22. Pursuant to the clear terms of clauses 8 and 9 of the LOU, the Signing Fee and Monthly Bonus would only be repayable by the Appellant wholly or in part in the event of termination of the Appellant's contracts with Company B during the five years. The Appellant has not referred the Board to anything in the contracts signed by him with Company B which shows otherwise.

23. Any repayment obligation under the LOU is therefore clearly a contingent liability only. The contingency has not arisen; and, as pointed out by Miss Wong on behalf of the Commissioner, if and in so far as the contingency shall arise subsequently, the amount that he will have to repay to Company B would be deductible in the assessment year when the repayment obligation arises under section 16(1) of the IRO.

24. This case is therefore indistinguishable from the decision in D85/03 (unpublished), which this Board considers should be followed.

25. The Board, however, differs from the Determination in relation to the 'Initial Signing Fee' of HK\$585,811 accrued or deemed to have accrued to the Appellant on 1 March 2002 and the Monthly Bonus of HK\$48,818 accrued or deemed to have accrued to the Appellant on 31 March 2002. The relevant year of assessment is 2002/03, that is, the 12 months commencing 1 April 2002 and ending on 31 March 2003. These two sums did not accrue to the Appellant during the assessment year but the previous assessment year.

26. Accordingly, the Board reduces the assessment for the assessment year 2002/03 as follows:

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Assessable profits as per Determination paragraph (6)(a)	\$1,886,274
<u>Less receipts accrued in assessment year 2001/02</u>	<u>(\$634,629)</u>
Revised assessable profits	\$1,251,645
<u>Less allowances</u>	<u>(\$306,000)</u>
Revised net chargeable income	<u>\$945,645</u>
Revised tax payable	\$150,259

Postscript

27. As mentioned above, the hearing of the appeal was adjourned on 16 March 2005 to enable the Appellant to respond to the Commissioner's written submissions. The Appellant responded by letter dated 22 March 2005, and supplied to the Board further documentary information in the form of another similar case concerning another agent of Company B (with the written consent of that other agent) whose position appears to be identical to that of the Appellant. It would appear that in that other case, the other agent also apportioned the 'Initial Signing Fee' received from Company B into five years in the same way as the Appellant did in this case, but the Commissioner had apparently not challenged the other agent's tax returns for assessment years 2002/03 and 2003/04. The Appellant therefore relied on this other case in support of his appeal.

28. The Commissioner, in response, urged this Board not to take into account the other case on the basis that the Inland Revenue Department is prohibited by section 4 of the IRO from disclosing information relating to the other agent. It was pointed out that because of the adoption of the 'Assess First, Audit Later' system since April 2001, the assessments of the other agent might not have been audited, and the Commissioner could raise additional assessments under section 60 of the IRO within the time specified therein. The Commissioner further submitted that since the other case is not a decision of this Board or a court decision, it is not a fact relevant to the present appeal.

29. This Board is of the view that the other case referred to by the Appellant is not relevant for the determination of this appeal and, even if relevant, will not attach any weight to it. The Board's duty is to determine this appeal on what it considers to be the correct basis on the facts of this case as found by it. In discharging its duty, the Board is bound to consider relevant previous decisions and follow binding authorities. But the Board is not concerned with whether the Commissioner's treatment of any other case is or may be wrong or inconsistent with what this Board considers to be the correct basis.