Case No. D29/99

Profits Tax – future contracts in USA – whether outgoings deductible – Inland Revenue Ordinance, section 16(1).

Panel: Terence Tai Chun To (chairman), Colin Cohen and Nigel Kat.

Dates of hearing: 22, 23 March and 19 April 1999.
Date of decision: 23 June 1999.

Company B1 was a wholly owned subsidiary of the taxpayer at all material times. In February 1983, the taxpayer and Company E agreed to set up a clearing arrangement between the 2 companies whereby Company E would clear the trade of Company B1 and the taxpayer in index contracts on an omnibus basis for trade on the United States Commodity Exchange for a fee. Pursuant to that agreement, an account with Company E was reactivated in the name of Company B1, and there was trade in future contracts involving margin calls, Company E accepting and executing trade orders placed in the name of Company B1's account. The profits from these transactions were from time to time credited to an account with a bank in USA identified the taxpayer as the beneficiaries.

In a High Court action instituted by Company E against the taxpayer and Company B1, it was held that the taxpayer as a contracting party to the 1983 agreement, was liable for the losses. Company B1 was also held liable because it had allowed itself to be used via its 1981 omnibus account.

In its profits tax returns for the years of assessment 1987/88 to 1995/96, the taxpayer claimed, inter alia, the following expenses and provisions as allowable deductions:

(a) Provision for bad debts in the sum of $79,897,330 paid for settlement of the litigation;

(b) Interest expenses for financing the litigation; and

(c) Legal fees.

The Revenue maintained that since these losses and related expenses and provisions arose from future contracts in USA, they were offshore losses and as such were not deductible because they were not incurred in the production of chargeable profit.

The taxpayer advanced 3 propositions to show that it was entitled to deductions as claimed:

(1) Each of Company B1 and the taxpayer had a direct contractual relationship with Company E;

(2) The taxpayer was an undisclosed agent for Company B1; &

(3) Sole relationship between the taxpayer and Company E.

Held:

The Board found that the taxpayer's relationship with Company E was one of principal to principal and it was on account of this relationship that the taxpayer was held liable for the losses incurred in the US omnibus account. As the source flowed from a source outside Hong Kong, it would not be deductible because it was not incurred in the production of chargeable profit. (55/95, Freeman and Locker v Buckhurst Park Properties (Magnal) Ltd, Bowstead & Reynolds on Agency, 16th Ed, Placer Pacific Management Pty Limited v FC of T, CIR v Cosmotron Manufacturing Co Ltd, CIR v Swire Pacific Ltd, Strong & Co of Romsey Limited v Woodfield, D60/91 referred)

The Board rejected all the 3 propositions advanced by the taxpayer. As to (1), the Board found the taxpayer did not assume the settlement risk of the omnibus account simply by accepting management fees (if it did). As to (2), the Board found that there was no principal and agent relationship between the taxpayer and Company B1 and thus the outgoings were not incurred in the production of profits chargeable to tax (the management fees). As to (3), the Board found it unrealistic to draw the inference that the outgoings were incurred in the production of commission which did not appear on the accounts.

Thus the taxpayer failed to discharge its burden of proving that the assessments were wrong.

Appeal dismissed.

Cases referred to:

D55/95, IRBRD, vol 11, 10
Freeman & Locker v Buckhurst Park Properties (Magnal) Ltd [1994] 2 QB 480
Bowstead & Reynolds on Agency, 16th Ed, Chpt 9, 559
Placer Pacific Management Pty Limited v FC of T 95 ATC 4440
CIR v Cosmotron Manufacturing Co Ltd [1997] HKLRD 1161
CIR v Swire Pacific Ltd [1979] HKTC 1145
Strong & Co of Romsey Limited v Woodfield (1906) AC 448
D60/91, IRBRD, vol 6, 450

Robert Andrews instructed by Department of Justice for the Commissioner of Inland Revenue.
Dow Famulak instructed by Messrs Baker & Mckenzie for the taxpayer.

Decision:

1. This is an appeal by the Taxpayer against the determination of the Commissioner dated 16 September 1997 in respect of profits tax assessments as follows:

(1) Profits tax assessment for the year of assessment 1991/92 dated 28 December 1995, showing net assessable profits of $4,583,582 (after set-off of loss brought forward of $293,655) with tax payable thereon of $756,291 is hereby increased to net assessable profits of $4,719,350 (after set-off of loss brought forward of $157,887) with tax payable thereon of $778,692.

(2) Profits tax assessment for the year of assessment 1992/93 dated 28 December 1995, showing assessable profits of $7,166,479 with tax payable thereon of $1,254,133 is hereby confirmed.

(3) Profit tax assessment for the year of assessment 1993/94 dated 28 December 1995, showing assessable profits of $10,704,869 with tax payable thereon of $1,873,352 is hereby confirmed.

(4) Profit tax assessment for the year of assessment 1994/95 dated 28 December 1995, showing assessable profits of $17,094,893 with tax payable thereon of $2,820,657 is hereby confirmed.

(5) Profits tax assessment for the year of assessment 1995/96 dated 26 November 1996, showing assessable profits of $20,999,534 with tax payable thereon of $3,464,923 is hereby confirmed.

2. The Taxpayer claims that certain deductions should be made in the computation of its assessable profits.

3. The following facts and the issue before us for decision were agreed between the parties and set out in a statement, as follows:

1. Company A (the ‘Taxpayer’) was incorporated on 1 June 1976 in Hong Kong under the name of Company B. It changed to its present name in 1977. Its ultimate holding company was Company C, a company incorporated in Hong Kong.

2. Company B1 was incorporated in Hong Kong on 31 March 1970. Company B1 was a wholly owned subsidiary of the Taxpayer from 15 December 1976 until 16 April 1987. Its principal activity at all relevant times was as a licensed broker in Hong Kong for gold and commodity futures trading.

3. The Taxpayer has objected to the profits tax assessments for the years of assessment 1991/92 to 1995/96 raised on it. The relevant issues herein relate to deductions claimed by the Taxpayer in respect of:

   (a) the legal fees it incurred in certain litigation;

   (b) the interest expenses it incurred in financing certain litigation; and

   (c) sums payable in settlement of litigation.

4. The facts relevant to the litigation payment are, amongst others, as follows:

   (a) In or around February 1983, there was an oral agreement between Mr D acting on behalf of Company E and Mr F acting for and on behalf of the Taxpayer, to set up a clearing arrangement between the two companies whereby Company E would clear the trade of Company B1 and the Taxpayer in index contracts on an omnibus basis for trade on the United States Commodity Exchanges for a fee.

   (b) Pursuant to that agreement an account with Company E was re-activated in the name of Company B1, and there was trade in future contracts involving margin calls, Company E accepting and executing trade orders placed in the name of Company B1's account.

   (c) The profits from these transactions were from time to time credited to an account with a bank in USA identified as:

      Account No

      Beneficiaries the Taxpayer

      By order of Company B1

   (d) In January 1983, Mr F had been introduced to Mr D and during the course of discussions to open an omnibus account with Company E, Mr F told Mr D:

Judgement of bundle page 26 *'... that he was an employee of Company A and that Company A wished to establish a clearing relationship with Company E. Thereupon, Mr F described Company A as a large trading company with tens of thousands of assets, numerous customers and a good prospect to grow. Mr F concluded that Company A wished to open an omnibus account with Company E evidently as brokers ... Not only did Mr F try to impress upon Mr D that Company A was a large trading company with tens of millions of dollars in assets and numerous customers but also that it was supported by shareholders who were very wealthy.'*

(e) Judgement at bundle pages 26-28 *'... Mr D had no doubt that the approach and the discussion to follow were made on behalf and for the benefit of Company A ... Mr F's business card described him as the managing director of Company A and on it were printed Company B1 ... as subsidiary companies ... It was explained that they were wholly owned subsidiaries of Company A. Mr F was not specific as to how the omnibus account would actually be operated but he indicated that one of them might be used as an operational company for futures trading but that Company E's relationship would be with Company A. Rates of commission were also discussed and the rates outlined to Mr D would seem acceptable to Mr F on the basis of 2,500 round turn contracts each month. Mr F expected to build up to that volume gradually.'*

(f) These were matters of fact disputed by Company A in circumstances where Mr F had been in court during Mr D's testimony had listened to the account of the meeting given by Mr D and was available to give evidence.

Judgement at bundle pages 29-30 *'Company A defence discloses a clear factual conflict on the discussions in the first meeting, particularly as to whether Mr F told Mr D that he was acting for Company A or negotiating for Company B1. Mr F's alleged role as a negotiator for Company B1 is not now sought to be supported. ... Mr D was firm that Mr F was acting for Company A whose name was specifically mentioned also in the second brief meeting for about 5 minutes.'*

(g) That Company A had abandoned the assertion that Mr F was a negotiator for Company B1 was confirmed at:

Judgement at bundle page 30 *'It was not and apparently could not be put to Mr D that his recollection was wrong ... Counsel for*

Company A confined himself to challenging the quality of Mr D's recollection.'

(h) Judgement of bundle pages 39-40 *'Company A had never been a future broker or dealer licenced in Hong Kong. In the directors' report of Company A ... the group activities included commodity futures trading. These were evidently activities of a subsidiary. Company A would need no omnibus account for its use. It had no licence for dealing in futures and no customers for an omnibus account. It was therefor suggested that Company A would not likely to have entered into an omnibus account with Company E ... But Mr D's evidence was that the relationship was with Company A which was to be responsible. The mechanics were to be arranged. Indeed it was so arranged that Company B1's dormant omnibus account was re-opened for operational purposes. In my view the more probable inference is that the 1981 dormant omnibus account would never have been re-activated without the 1983 discussion and agreement of Company A for favourable commission rates. Mr F indicated without any firm commitment that any one of three subsidiaries might be used for trading. Mr D raised no objection to it: then what had been agreed to by Company A was put into action through a subsidiary.'*

Judgement at bundle page 41 *'Company A used Company B1 as a trading vehicle and had no or no special account of its own.'*

(i) As assertion supported by the court's finding at:

Judgement on bundle page 45 *'that minutes of the director's meetings of Company A held between 1981 and 1983 suggest that Company A was trading through its subsidiary Company B1.'*

(j) In the outcome the court found at:

Judgement at bundle page 45 *'In the final outcome I accept Mr D's evidence is credible and accurate. Company E's relationship was indeed with Company A. I find that Company A was liable as claimed in consequence of the 1983 discussions and agreement. Company B1 allowed itself to be used via its 1981 omnibus account and is therefor liable.'*

(k) The Taxpayer lodged an appeal against this judgement before the Hong Kong Court of Appeal and put up a deposit with a bank for this purpose. The deposit was in the amount of US$9,118,844.50 as at 31 March 1990.

(l) On 6 March 1991, the Hong Kong Court of Appeal dismissed the appeal (a copy of the judgement of the Court of Appeal is attached beginning at page 51 of the Board's bundle). The Taxpayer lodged a further appeal to the Privy Council and put up a deposit with a bank for this purpose. The deposit was in the amount of US$10,903,421.39 as at 31 March 1991.

(m) In the course of the year of assessment 1991/92, the Taxpayer withdrew its appeal to the Privy Council and paid Company E a sum of HK$79,897,330 (that is US$10,300,000) as full and final settlement of the litigation which sum was made up of the losses incurred on the omnibus account, the interest thereon and the plaintiff's costs. The Taxpayer did not recover the amount from Company B1 because the latter did not have any assets. Instead, the Taxpayer took a provision for bad debts in respect of this amount in the year of assessment 1991/92.

(n) That deposits referred to in (k) and (l) above generated interest income. However, the Taxpayer had borrowed money from a related company in order to finance the deposit. The Taxpayer paid interest to the related company for this borrowing. Details of the interest income earned from the deposit and the interest expense paid for the borrowing are as follows:

Year of Assessment	**Interest Income($)**	**Interest Expense($)**
1990/91	6,115,776.86	6,413,813.62
1991/92	3,448,197.35	3,681,525.65

(o) The Taxpayer has incurred the following legal fees in respect of the High Court proceedings and the subsequent appeals:

Year of Assessment	**Legal fees**
1987/88	402,627
1988/89	1,663,561
1989/90	2,921,562
1990/91	2,547,213
1991/92	1,855,798

5. In its profits tax returns for the years of assessment 1987/88 to 1995/96, the Taxpayer claimed, amongst others, the following expenses and provisions as allowable deductions:

(a) Provision for bad debts the sum of $79,897,330 paid for settlement of the litigation (subparagraph 4(m) above);

(b) Interest expense for financing the litigation (subparagraph 4(n) above); and

(c) Legal fees in respect of High Court proceedings and subsequent appeals (subparagraph 4(o) above).

Concurrently, the Taxpayer offered for assessment the interest income earned from the deposit made for the purpose of the appeal against the judgement of the High Court (subparagraph 4(n) above).

6. The assessor recomputed the Taxpayer's losses for the years of assessment from 1987/88 to 1990/91 and profits tax for the years of assessment form 1991/92 to 1994/95 as follows (items contested herein are highlighted):

Year of Assessment 1987/88

Loss per return		($4,385,310)
Less :Legal fees for High Court Action	$402,627	
Specific provision for doubtful debt due from Madam G	$1,432,378	$1,835,005
Assessed loss for the year		($2,550,305)
Loss brought forward		($1,378,917)
Loss carried forward		($3,929,222)

Year of Assessment 1988/89

Loss per return		($5,450,109)
Less :Legal fees for High Court Action	$1,663,561	
Specific provision for doubtful debt due from Madam G	$1,048,122	
Provision for debts assigned by Company B2	$1,717,075	

Other professional fees as agreed	$29,075	$4,457,833
Assessed loss for the year		($992,276)
Loss brought forward		($3,929,222)
Loss carried forward		($4,921,498)

Year of Assessment 1989/90

Loss per return		($8,591,505)
Less : Legal fees for High Court Action	$2,785,794*	
Specific provision for doubtful debt due from Madam G	$19,739	
Provision for debts assigned by Company B2	$4,006,521	
Other professional fees as agreed	$199,343	$7,011,397
Assessed loss for the year		($1,580,108)
Loss brought forward		($4,921,498)
Loss carried forward		($6,501,606)

* The assessor omitted to include an amount of $135,768 (see paragraph 10 below)

Year of Assessment 1990/91

Profits per return		($1,207,154)
Less : Legal fees for High Court Action	$2,547,213	
Net interest paid for financing the above litigation (6,413,813 – 6,115,776)	$298,037	
Interest paid for financing non-performing loans to Company A1	$2,155,547	$5,000,797
Assessable profits		$6,207,951
Loss brought forward	($6,501,606)	

Less: Set-off of loss	$6,207,951	($6,207,951)
Loss carried forward	($293,655)	
Net assessable profits		Nil

Year of Assessment 1991/92

Loss per return		($78,966,942)
Less :Legal fees for High Court Action and its appeals	$1,855,798	
Net interest paid for financing the above litigation (3,681,525 – 3,448,176)	$233,328	
Provision for debts due by Company B1	$79,897,330	
Interest paid for financing non-performing loans to Company A1	$1,857,723	$83,844,179
Assessable profits		$4,877,237
Less: Set-off of loss brought forward		($293,655)
Net assessable profits		$4,583,582
Tax payable thereon		$756,291

Year of Assessment 1992/93

Profits per return	$5,882,819
Add: Interest paid for financing non-performing loans to Company A1	$1,283,660
Assessable profits	$7,166,479
Tax payable thereon	$1,254,133

Year of Assessment 1993/94

Profits per return	$9,629,017

Add:	Interest paid for financing non-performing loans to Company A1	$1,075,852
	Assessable Profits	$10,704,869
	Tax payable thereon	$1,873,352

Year of Assessment 1994/95

	Profits per return	$16,171,501
Add:	Interest paid for financing non-performing loans to Company A1	$923,392
	Assessable profits	$17,094,893
	Tax payable thereon	$2,820,657

(For the years of assessment 1992/93 to 1994/95, success by the Taxpayer in the appeal would affect the tax payable for the fact that the Taxpayer would then have losses carry-forward to claim against the assessable profits as computed by the assessor.)

7. The Taxpayer's then tax representatives, Messrs Chan, Lai Pang & Co, objected to the assessments on the grounds that, amongst others, the following items should be allowable deductions:

	Professional fee re High Court Action	**Net interest paid for financing the litigation**	**Provision for bad debts**
1987/88	$402,627		
1988/89	$1,663,561		
1989/90	$2,785,794		
1990/91	$2,547,213	$298,037	
1991/92	$1,855,798	$233,328	$79,897,330

8. The Taxpayer changed tax representatives to Ernst & Young ('E&Y') who maintained the position that the items in paragraph 7 above should be allowable deductions.

9. The representative stated that the Taxpayer had received the following management fees from Company B1:

Year of Assessment	Management fees
1982/83	$1,346,307
1983/84	$1,267,223
1984/85	$1,320,000
1985/86	$1,320,000
1986/87	$1,403,804*
1987/88	$696,792

* this amount should be $1,722,116

10. The assessor is now of the opinion that the loss positions for the years of assessment 1989/90 and 1990/91 should be re-computed as follows:

Year of Assessment 1989/90

Loss previously assessed	($1,580,108)
Less: Adjustment of legal fees of High Court Action omitted	$135,768
Assessed loss for the year	($1,444,340)
Loss brought forward	($4,921,498)
Loss carried forward	($6,365,838)

Year of Assessment 1990/91

Profits previously assessed		$6,207,951
Loss brought forward	($6,365,838)	
Less: Set-off of loss	$6,207,951	$6,207,951
Loss carried forward	($157,887)	
Net assessable profits		Nil

He is also of the opinion that the assessment for the year of assessment 1991/92 should be revised as follows:

Assessable profits	$4,877,237
Less: Set-off of loss brought forward	($157,887)
Net assessable profits	$4,719,350
Tax payable thereon	$778,692

11. The issue before the Board is whether the expenses set out at paragraph 7 above are allowable expenses for the Taxpayer in the relevant years of assessment.

4. We also heard evidence of fact from Messrs Peter Wong and William Wu of the Taxpayer. We refer to parts of their evidence below, although we have of course considered carefully all they had to say. The Commissioner called no oral evidence.

5. At the hearing the Taxpayer was represented by Mr Famulak of Baker & McKenzie.

6. The Commissioner was represented by Mr Robert Andrews of Counsel.

The law

7. In the course of the hearing, we were referred to the following authorities:

D55/95, IRBRD, vol 11, 10;

Freeman & Locker v Buckhurst Park Properties (Magnal) Ltd, [1994] 2 QB 480 at 502-3;

Bowstead & Reynolds on Agency, 16th Ed, Chpt 9, page 559;

Placer Pacific Management Pty Limited v FC of T 95 ATC 4440;

CIR v Cosmotron Manufacturing Co Ltd [1997] HKLRD 1161;

CIR v Swire Pacific Ltd [1979] HKTC 1145;

Strong & Co of Romsey Limited v Woodfield (1906) AC 448;

D60/91, IRBRD, vol 6, 450 at page 455.

Several sections of the Inland Revenue Ordinance (the IRO) were also drawn to our attention, the main section being section 16(1).

Section 16(1) '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 ...'

The Revenue's case

8. As a result of an oral agreement between Company E and the Taxpayer in February 1983, Company E would, for a fee, clear the trade of the Taxpayer and its wholly owned subsidiary Company B1 in respect of trading index contracts on an omnibus account on the United States Commodity Exchanges.

9. The omnibus account had previously been opened in the name of Company B1 in 1981 and left dormant. It was simply re-activated pursuant to the 1983 agreement whereby Company E would accept and execute trade orders placed in the name of Company B1 in respect of futures contracts involving margin calls.

10. Losses were subsequently incurred in the omnibus account. In a High Court action instituted by Company E against the Taxpayer and Company B1, it was held that the Taxpayer, as a contracting party to the 1983 agreement, was liable for the losses. Company B1 abandoned interest in the High Court proceedings but was held nevertheless to be liable because it had allowed itself to be used via its 1981 omnibus account.

11. It was the Revenue's case that since these losses arose from futures contracts in USA, they were offshore losses and as such were not deductible because they were not incurred in the production of chargeable profit.

12. It follows that the amount paid pursuant to the Judgment, the legal fees incurred in defending the High Court action and the interest payments in respect of a loan to put up security for the continued defence of the proceedings were not monies incurred by the Taxpayer in the production of their profits.

The Taxpayer's case

13. In his submission, Mr Famulak, on behalf of the Taxpayer, advanced three possible relationships between the parties for the consideration of the Board in deciding whether the expenditure was incurred in the production of chargeable profits. Mr Famulak did not elect any one of these relationships to be his case but invited the Board to conclude that whatever the relationship the Taxpayer was entitled to deductions as claimed notwithstanding that in each case the Taxpayer was itself contracting with Company E.

14. It would be convenient to give a short summary of these relationships in the order in which they were advanced.

A. Each of Company B1 and the Taxpayer had a direct contractual relationship with Company E.

In 1981, Company B1 had opened an omnibus account with Company E.

In 1983, the Taxpayer and Company E had an agreement whereby the 1981 account was re-activated.

The 1983 agreement between the Taxpayer and Company E would not have existed if Company B1 had not opened the account with Company E.

It was submitted that since the Taxpayer agreed to assume Company B1's settlement risk in exchange for the management fees from Company B1, it should follow that the outgoings paid by the Taxpayer were incurred by the Taxpayer in the production of chargeable profit from the management fees.

B. The Taxpayer was an undisclosed agent for Company B1.

The Taxpayer received a fee for assuming the settlement risk of Company B1. The judgment of Mr Justice Liu was consistent with the Taxpayer being treated as an undisclosed agent for Company B1 because in agency law where the principal is undisclosed at the time of contracting, the agent is held liable. The outgoing paid by the Taxpayer were incurred in the production of chargeable profits (from the management fees).

C. Sole relationship between Taxpayer and Company E.

The Taxpayer and Company B1 did not trade on their own account.

Any profit or loss was that of the customers of the Taxpayer and Company B1. The outgoings were incurred for the production of chargeable profits (in this case, from the commission earned) were deductible.

In support of his case, the Taxpayer called two witnesses to give evidence. They were Mr H and Mr I. Their evidence is summarised as follows:

Evidence of Mr H

1. Mr H is the group managing director of Company A2.

2. In November 1987, Mr H was the chief operating officer, director and general manager of the group companies owned by the Taxpayer.

3. The principal activities of the Taxpayer were to provide management services, money lending, foreign exchange dealings and investment holding.

4. Between 16 November 1987 and 8 July 1988, Mr H was the company secretary of Company B1 responsible, among other things, for the proper corporate documentation and compliance requirements of the relevant regulatory bodies.

5. As chief operating officer, Mr H's areas of responsibility were (i) to review and re-design the financial and operational system of the group and (ii) to formulate corporate strategy for the group and to assist the group to

expand and improve its business to its fullest extent potential for flotation purposes. For his work, Mr H had to acquaint himself with the business and orgainsation structure of the group . He was also closely involved with the Taxpayer litigation with Company E which resulted in a settlement payment which is the main issue before the Board. Mr H's evidence was based upon, he told us, conversations with other management staff of the group and upon a review of various documents for those purposes.

6. Mr H observed that the Taxpayer assumed the following roles for companies within the group:

(a) providing loans and financial support,

(b) providing guarantee to outsiders,

(c) acting as clearing house and,

(d) providing centralised management and strategic planning services.

7. Mr H cited instances in which Company B1 did request the Taxpayer to provide guarantees, although he was unable to produce such a guarantee or resolution of the Taxpayer to so guarantee the omnibus account.

8. The Taxpayer set up a management team for the purpose of providing various services to the group, Company B1 included. The management team consists of (1) Mr J, in charge of the financial administration of the group (2) Mr K, himself the general manager of Company B1, in charge of the overall securities dealing business and (3) Mr I responsible for the futures and commodity trading.

9. For the provision of such services, Mr H found that the Taxpayer would receive a management fee from each of the trading companies within the group.

10. He believed 'the spirit of the management fee' was to compensate the Taxpayer for (a) assuming the business risk in relation to the operation of the trading companies and (b) providing managerial and supervising functions but no contemporaneous or documentary evidence to support this assertion was drawn to our attention.

11. It was Mr H's understanding of the business and operational structure of the group that subsidiaries of the Taxpayer, Company B1 included, were entitled to rely on the financial strength of the group when required to

submit financial credentials. We noted that, however, guarantees were usually sought of and provided by Company A for futures trading by its subsidiaries.

12. It was also the understanding of Mr H that Company B1 obliged to pay management fees to the Taxpayer in return for the Taxpayer's authorising Company B1 to use and benefit from the reputation and financial backing of the Taxpayer in Company B1's dealings with third parties.

13. By virtue of the authorisation, the Taxpayer implicitly accepted the business and financial risks of Company B1.

Evidence of Mr I

(1) Mr I is the executive director (finance) of Company A2.

(2) Mr I joined Company B1 in 1986 as the accounts manager.

(3) In 1992, he was an accounts manager with Company A2, joining the Taxpayer in 1996.

(4) He was not familiar with the Taxpayer's accounts prior to the hearing of this matter.

(5) The principal activity of Company B1 was acting as broker in Hong Kong for gold and commodity future trading.

(6) Mr I was responsible for the operational side of gold and commodity dealing business of Company B1, especially for overseeing the customer's trading accounts to monitor the margin level of those accounts.

(7) Mr I set out in details the steps taken regarding a typical futures trade concluded by Company B1 with Company E.

(a) A customer would place an order with the operation desk of Company B1 for a commodity futures contract traded in the US;

(b) The operation desk would place an order with Company E to trade from its omnibus account a contract for the relevant futures commodity;

(c) On the same day, Company E would telex Company B1 to confirm the order and to request payment of a certain sum

being the margin profit/loss plus the commission charged by Company E;

(d) Company B1 would pass the request from Company E to the Taxpayer.

(e) The Taxpayer would remit directly to Company E on behalf of Company B1 the required amount in US dollars;

(f) At the same time, the Taxpayer would debit the account of Company B1 for the amount it paid to Company E on behalf of Company B1.

(8) The Taxpayer would charge interest on the amount advanced on behalf of Company B1 to Company E.

(9) In addition, Company B1 would also pay the Taxpayer management fees.

(10) Total management fees received from Company B1 and total amount of fees received from all sources by the Taxpayer were booked as set out below:

Year of assessment	**Management fees received from Company B1**	**Total management fees received by Taxpayer**
	$	$
1982/83	1,346,307	2,692,614
1983/84	1,267,223	2,534,455
1984/85	1,320,000	2,490,000
1985/86	1,320,000	2,280,000
1986/87	1,722,000	2,704,667
1987/88	696,792	2,318,216
1988/89	N/A	1,540,000
1989/90	N/A	2,222,500
1990/91	N/A	7,653,557
1991/92	N/A	5,665,278
1992/93	N/A	8,893,683
1993/94	N/A	11,973,552
Total	7,672,438	52,971,522

15. However, it was unclear whether these fees had in fact been paid other than for 2 years for which there were vouchers.

Conclusion

16. From the statement of agreed facts and the evidence of the Taxpayer's two witnesses, Mr H and Mr I, we find that the Taxpayer's relationship with Company E was one of principal to principal and it was on account of this principal to principal relationship that the Taxpayer was held liable for the losses incurred in the US omnibus account. As the loss flowed from a source outside Hong Kong, it would not be deductible because it was not incurred in the production of chargeable profit.

17. In order to discharge its onus under section 68(3) of the IRO, the Taxpayer put forward three propositions. We shall deal with them in turn.

A. Each of Company B1 and the Taxpayer had a direct relationship with Company E.

1. The main thrust of the Taxpayer's case under this head was that in accepting management fees from Company B1, the Taxpayer assumed the settlement risk of the omnibus account.

2. Hence the payments of the settlement sum in the High Court action, the legal fees and the loan interest were outgings incurred by the Taxpayer in the production of chargeable profits out of the management fees.

3. No contemporaneous or documentary evidence from the Taxpayer itself, such as a letter, agreement or even a board or directors' resolution, was adduced to show that the Taxpayer ever agreed to assume the 'settlement risk' of the omnibus account.

4. Mr H, one of the Taxpayer's two witnesses could at best assert that 'the spirit of the management fee' was to compensate the Taxpayer for, among other things, assuming the business risks of the omnibus account. This assumption was, he frankly admitted, his 'impression' which was difficult to substantiate. In addition, the Taxpayer allowed Company B1 to take advantage of its reputation and financial backing in dealing with third parties and as a result, the Taxpayer implicitly accepted the financial risks of Company B1.

5. It was understandable that Mr H could not be more specific in his evidence. He was not with the Taxpayer in 1983 when the 1981 omnibus account was re-activated. He had no first hand knowledge of the affairs of the Taxpayer prior to 1987. He did not know why the 1981 account was re-activated. He could not tell how management fees were calculated. Mr I, the Taxpayer's second witness, could not assist on this point. As a result, we did not find the evidence on the management fees helpful either way.

6. There was evidence that the Taxpayer had on several occasions put up a bond or guarantee to enable Company B1 to trade on the appropriate exchange and on such occasions there was a resolution from the Company B1's board requesting the Taxpayer to provide such a bond or guarantee. By contrast, in the case of the omnibus account, no such request was contained in Company B1's resolution. Its absence pointed strongly to the fact that the Taxpayer did not put up a bond or a guarantee in respect of the re-activated 1981 omnibus account. Although Mr H believed it had done so, he was unable to produce any guarantee. Further, the Taxpayer did not have a resolution showing that it was prepared to provide a guarantee for the omnibus account.

7. We find that the reality of the position was that the Taxpayer made itself liable on the omnibus account by contracting as principal with Company E.

8. The Taxpayer through Mr F was the party who negotiated with Company E for the re-activation of the 1981 account and obtained favourable commission rates and it was the Taxpayer who was to decide how the omnibus account was to be operated.

9. It did not appear to follow that, simply by accepting management fees (if it did), the Taxpayer had expressly or implicitly agreed to assume the business or settlement risk of the omnibus account.

B. The Taxpayer as undisclosed agent for Company B1.

The Taxpayer submitted that, as a second alternative proposition, the Taxpayer was an undisclosed agent of Company B1. He based his submission on Mr H's assertion to the effect that the Taxpayer received a management fee for assuming the settlement risk of Company B1. There was no evidence to support Mr H's assertion.

Although the argument that the Taxpayer was an undisclosed agent of Company B1 was not mentioned in the proceedings before the courts nor was it mentioned before the Commissioner, we still consider this submission on its own merits.

The Taxpayer firstly submitted that the judgement of Mr Justice Liu was consistent with the principal-agent relationship between the Taxpayer and Company B1. We find this submission difficult to follow in view of the clear findings in the judgment of Mr Justice Liu.

'In the final outcome I accept Mr D's evidence is credible and accurate. Company E's relationship was indeed with Company A. I find that Company A was liable as claimed in consequence of the 1983 discussions and agreement. Company B1 allowed itself to be used via its 1981 omnibus account and it therefore liable.'

Each of the facts agreed that identify the Taxpayer as principal is relevant. We find no evidence to support an agency relationship, whether express or implied. Indeed, an agency is inconsistent with the reactivation and operation of the omnibus account by Company E at the Taxpayer's own request.

We have no hesitation in agreeing with Mr Justice Liu and holding that there was no principal and agent relationship between the Taxpayer and Company B1 and that the outgoings were not incurred in the production of profits chargeable to tax (in this case, the management fees).

C. Sole relationship between Taxpayer and Company E.

The Taxpayer submitted that, as an alternative proposition, only one relationship existed between the parties, that is, the relationship between the Taxpayer and Company E.

It was the Taxpayer's submission that the profits that the Taxpayer/Company B1 made from the trade were in fact made from the commissions earned from customers and booked in Company B1's accounts and offered to Hong Kong profits tax. As a consequence, the outgoings were incurred in the production of chargeable profits, that is, from the commissions.

The Taxpayer's PL accounts for the year ended 31 March 1983 showed that in 1982 the Taxpayer received a commission of $1,000,000. Notably, the evidence did not identify that commission with any particularity.

Mr H, the Taxpayer's principal witness, said that he had no idea of what the $1,000,000 commission was all about.

He was not in a position to say as to how the Taxpayer would be earning the $1,000,000 commission or from whom was such commission received.

Nor could Mr I assist greatly on the point.

As a result, there was no evidence to show that the $1,000,000 commission received in 1982 related to trades arising form the omnibus account.

From the relevant accounts of the Taxpayer it was established that, apart from the $1,000,000 commission received in 1982, the Taxpayer did not receive any commission during the relevant years.

We consider that it would therefore be unrealistic to draw an unsupported inference that the outgoings (settlement sum, legal fees and interest) were incurred in the production of commissions which did not appear on the accounts (the $1,000,000 commission excepted).

Further, we do not agree that from the facts before us, only one relationship existed between the parties.

The evidence clearly demonstrates that there were, as submitted by the Taxpayer as its first alternative proposition, 2 relationships between the parties respectively, that is, between the Taxpayer and Company E and between Company B1 and Company E.

Between Company B1 and Company E, there was the 1981 omnibus account which was opened in the name of Company B1.

And between the Taxpayer and Company E, there was the 1983 clearing agreement leading to the reactivation of the 1981 account. And that was a principal to principal relationship between the Taxpayer and Company E, as was the trading on that account thereafter. The payment of the outgoings arose out of such a relationship and not out of any obligation which the Taxpayer had towards Company B1.

There was no contemporaneous evidence, certainly no documentary evidence, to show that the Taxpayer agreed to assume the settlement risk of the omnibus account.

The outgoing amounted to an offshore loss of the Taxpayer. They were not deductible under section 16(1) because they were not incurred in the production of chargeable profits.

Having reviewed all the evidence before us, we are unable to conclude that the outgoings were incurred for the purpose of earning the commissions.

Under section 68(4) of the IRO, the burden of proving that the assessments appealed against are incorrect falls on the Taxpayer. It is for the Taxpayer to put facts before us to show that the assessments were wrong.

We have carefully considered all the fact and matters put before us, including those to which we have not referred in our decision. We have also considered Mr Famulak's comprehensive submissions and the authorities to which he referred us.

Having regard to all the circumstances of this case, however, we are not satisfied that the Taxpayer has discharged its onus and we would dismiss the appeal accordingly.

There remains for us to thank Mr Andrews and Mr Famulak for supplying their helpful written submissions to the Board which made our task easier.