Case No. D3/07

Profits tax – whether or not the management fee was deductible – section 66(3) and 68(9) of the Inland Revenue Ordinance ('IRO') – principles on whether or not to allow additional ground on appeal – burden of proof.

Panel: Kenneth Kwok Hing Wai SC (chairman), Erik Shum and Michael Wilkinson.

Date of hearing: 22 March 2007.
Date of decision: 11 May 2007.

The appellant is a private company. The appellant claimed for deduction of management fee paid to the alleged service provider. The assessor did not accept that management fee was deductible and issued profits tax assessments. The appellant objected against the assessments.

The appellant argued that the management fees are necessary incurred for the production of the assessable profits and tax deductible. In the hearing for the appeal, the appellant applied to rely on the additional ground of appeal but the application was refused.

Held:

1. The original grounds of appeal confined to the issue of deductibility of the alleged management fee. The additional ground on the issue of rental income was plainly not in issue. Unless the Board gave consent, the appellant was precluded by section 66(3) from raising the question of rental income or from relying on the proposed further ground.

2. The Board considered that the principles in Hebei Enterprises Limited and others v Livasiri & Co (a firm) and others HCA 20094/1998, 3 June 2004 were equally applicable to an application under section 66(3), especially in respect of late applications.

3. In considering whether to allow the appellant to rely on the proposed further ground, the Board bore in mind the prejudice which the respondent might suffer. The Board found that the proposed further ground was unintelligible, devoid of material particulars, plainly unarguable and was prejudicial to the respondent.

4. Whether or not the appellant did incur the alleged expenses; whether or not the alleged expenses were incurred during the basis period and whether or not the alleged expenses were incurred in the production of profits are questions of fact. The onus is on the appellant. The Board is not satisfied on a balance of probabilities that the appellant had incurred any management fee and the appellant has failed to establish the factual basis for deduction.

Appeal dismissed and costs order in the sum of $4,000 imposed.

Case referred to:

Hebei Enterprises Limited and others v Livasiri & Co (a firm) and others, HCA 20094/1998, 3 June 2004, unreported.

Taxpayer represented by its director.
Fung Chi Keung and Leung To Shan for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal against the Determination of the Acting Deputy Commissioner of Inland Revenue dated 29 November 2006 by which:

(a) Profits tax assessment for the year of assessment 2000/01 under charge number 1-1123751-01-1, dated 25 May 2006, showing assessable profits of $287,845 with tax payable thereon of $46,055 was increased to assessable profits of $655,513 with tax payable thereon of $104,882.

(b) Profits tax assessment for the year of assessment 2001/02 under charge number 1-1078866-02-1, dated 7 January 2003, showing net assessable profits of $247,707 (after setting-off loss brought forward of $12,155) with tax payable thereon of $39,633 was increased to assessable profits of $316,063 with tax payable thereon of $50,570.

(c) Profits tax assessment for the year of assessment 2002/03 under charge number 1-1120370-03-3, dated 26 May 2006, showing assessable profits of $280,157 with tax payable thereon of $44,825 was increased to assessable profits of $306,268 with tax payable thereon of $49,002.

(d) Profits tax assessment for the year of assessment 2003/04 under charge number 1-1120612-04-5, dated 26 May 2006, showing assessable profits of $290,932 with tax payable thereon of $50,913 was increased to assessable profits of $317,070 with tax payable thereon of $55,487.

(e) Profits tax assessment for the year of assessment 2004/05 under charge number 1-1113121-05-8, dated 26 May 2006, showing assessable profits of $190,830 with tax payable thereon of $33,395 was increased to assessable profits of $208,416 with tax payable thereon of $36,472.

The salient facts

2. The salient facts are as follows.

3. The appellant is a private company which closes its accounts annually on 31 March. It is beneficially owned by the director ('the Owner') who represented the appellant at the hearing of the appeal.

4. In July 1991, the appellant purchased four units of a building in Hong Kong. According to three copy tenancy agreements produced by the appellant at the hearing of the appeal:

(a) three of the units were let for a term of two years commencing on 1 August 1998 at the monthly rental of $36,000, exclusive of rates, to another company ('the Alleged Service Provider') beneficially owned by the Owner.

(b) Those three units were let for a term of two years commencing on 1 August 2000 at the monthly rental of $36,000, exclusive of rates, to the Alleged Service Provider and a third company ('the Third Company') also beneficially owned by the Owner.

(c) All four units were let for a term of two years commencing on 1 August 2002 at the monthly rental of $36,000, exclusive of rates, to the Alleged Service Provider and the Third Company.

The appellant sold the four units in February 2005.

5. The objection process started with the appellant objecting against the 1998/99 and 1999/2000 profits tax assessments on the grounds that motor vehicle running expenses and depreciation allowance should be deductible. The outcome of the objections might have an effect on the amounts of loss being carried forward and the appellant made consequential objection against the 2001/02 profits tax assessment.

6. By 13 April 2004, the appellant accepted the assessor's disallowance of the hire purchase interest, motor vehicle expenses and depreciation allowance. The objections against the 1998/99 and 1999/2000 profits tax assessments were settled.

7. The assessor proposed to the appellant to make consequential revisions to the 2001/02 profits tax assessment.

8. The appellant disagreed and alleged that management fee of $300,000 had been omitted in the appellant's financial statements and tax computations for the year ended March 31, 2002.

9. The appellant's audited financial statements, detailed profit and loss accounts and profits tax computations showed that the Alleged Service Provider was the recipient of the management fee. They also showed the followings:

	1997/98	**1998/99**	**1999/2000**	**2000/01**	**2001/02**	**2002/03**	**2003/04**	**2004/05**
	$	$	$	$	$	$	$	$
Turnover	661,200	641,200	589,800	576,000	468,000	432,000	432,000	360,000
Adjusted loss	[1]	432,976	293,536	12,155	(259,862)[2]	19,843	9,068	(10,830)[3]
Rental income	661,200	641,200	589,800	576,000	468.000	432,000	432,000	360,000
Directors' remuneration	130,000	130,000	130,000	-	Nil	-	-	150,000
Rental income from the Alleged Service Provider	462,000	442,000	432,000	360,000	297,000	216,000	216,000	252,000
Rental income from the Third Company				72,000	135,000	216,000	216,000	252,000
Management fee to the Alleged Service Provider	186,000	24,000	-	300,000[4]	-	300,000	300,000	180,000[5]
Professional fee		19,805[6]	2,805	6,559	2,805[7]	3,805[8]	4,805[9]	2805
Salary and allowance/staff costs		53,883	140,166	18,096	-			
Taxation services fee			1,000	1,000	1,000			
Medical								14,900

[1] Where there is no information, the item is left blank
[2] Assessable profits
[3] Assessable profits
[4] The nature of the management fee as described in Schedule 7 was 'fee on provision of office supplies & accounting and management services for the year',
[5] $15,000 per month for 12 months from April 2004 to March 2005
[6] Including capital expenses of $5,000
[7] Described as 'secretarial fee'
[8] Comprising taxation service fee of $1,000 and company secretarial fee of $2,805
[9] Comprising taxation service fee of $1,000 and company secretarial fee of $3,805

10. The audited financial statements of the Alleged Service Provider showed the following on related party transactions with the appellant:

	2000/01	**2001/02**	**2002/03**	**2003/04**	**2004/05**
	$	$	$	$	
Rental expenses	360,000	306,180[10]	216,000	216,000	[11]
Management fee income			300,000	300,000	

11. In May 2005, the appellant provided the assessor with the following copy documents in support of its claim for deduction of management fee:

(a) a purported agreement dated 1 April 2000 said to be made between the appellant and the Alleged Service Provider ('the Purported April 2000 Agreement'); and

(b) purported minutes of a meeting of the appellant's Board of Directors said to be held on 31 March 2000 ('the Purported March 2000 Minutes').

12. The Report of the Directors in the appellant's audited financial statements for the years 1998/99 to 2001/02 showed that the Owner's mother was not a director of the appellant. The Report of the Directors for 2002/03 dated 15 November 2003 was signed by the Owner. It showed that the Owner's mother was appointed a director of the appellant on 23 April 2003.

The Report of the Directors for 2003/04 dated 20 August 2004 was signed by the Owner. It showed that the Owner's mother was appointed a director of the appellant on 23 April 2003.

13. The Report of the Directors in the Alleged Service Provider's audited financial statements for the year 2000/01 showed that the Owner's mother was not a director of the Alleged Service Provider.

The Report of the Directors for 2001/02 showed that the Owner's mother was appointed a director of the Alleged Service Provider on 1 December 2001.

14. The assessor did not accept that management fee was deductible and issued to the appellant profits tax assessments for 2000/01, 2002/03, 2003/04 and 2004/05. The appellant objected against the assessments.

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[10] The comparative figure shown in the audited financial statements for 2002/03 is $297,000, instead of $306,180

[11] The Alleged Service Provider claimed exemption from the disclosure requirement on related party transactions

15. The Acting Deputy Commissioner disagreed with the objections and issued the Determination dated 29 November 2006. By paragraph 3(3)(a) of his Determination, he made it plain that he did not accept that the Purported April 2000 Agreement and the Purported March 2000 Minutes were contemporaneous documents:

> '[The appellant] provided copies of [the Purported April 2000 Agreement] and [the Purported March 2000 Minutes] to support its claim. However, [the Owner's mother's] appointment as director of [the Alleged Service Provider] on 1 December 2001 ... and [the appellant] on 23 April 2003 ... did not tally with the dates of these documents. In the circumstances, I do not accept that they are contemporaneous documents nor I am able to put any weight on them when considering [the appellant's] claim. I am not satisfied that [the appellant] had any contractual liability to pay the alleged management fee to [the Alleged Service Provider].'

The Notice of Appeal

16. By letter dated 18 December 2006, the appellant gave notice of appeal in the following terms (written exactly as in the original):

> 'We appeal against the treatment of the management fees for the years 2000/01 to 2004/05. We consider that the management fees are necessary incurred for the production of the assessable profits and tax deductible on the following grounds:
>
> i) [The appellant] is engaged in investment property and earned rental income which is subject to Hong Kong profits tax. The property purchased was leased out to third party as well as to [the Alleged Service Provider], a related company. The rental was at market rate.
>
> ii) [The appellant] has not employed any staff and all the daily administration and accounting duties are performed by its related company [the Alleged Service Provider]. We do not consider paying a fee to a related company for handling [the appellant's] administration function is unreasonable. [The appellant] has no staff cost in its accounts. We would appreciate if you could understand that it will also cost us to employ a staff to handle the daily operation of [the appellant] not to mention the time and cost in training and/or supervising the staff. Staff of [the Alleged Service Provider] assist [the appellant] in daily administration function (i.e. liaising with the tenant on rental payment, rental period extension/termination, operating of bank account etc.), and ensure compliance of statutory requirements (i.e. filing of annual return to the Company Registry, preparation of accounts and handle tax filing etc.).

> Charging [the appellant] for the use of the Group resource to our point of view is reasonable and with commercial sense. Especially, the fee was only HK$25,000 per month for the years ended 31 March 2001 to 2004 and HK$15,000 per month for the year ended 31 March 2005. If [the appellant] had employed an individual to oversee the daily operation the management believes that a monthly salary and benefit of HK$25,000 should have been incurred.
>
> iii) The fee was booked through current account with related company. We do not agree this is unreasonable for a company to charge its fee through current account and this is not an abnormal practice in doing business.
>
> We would also appreciate if we would arrange a meeting to present to you in respect of the management fee.'

The appeal hearing

17. At the hearing of the appeal, the appellant was represented by the Owner and the respondent by Mr Fung Chi-keung.

18. The Purported April 2000 Agreement purported to be made on 1 April 2000 and signed by a director of the appellant and a director of the Alleged Service Provider. It was an agreement for the provision by the Alleged Service Provider to the appellant of 'manpower and authorized signatories to handle the administration and banking affairs in Hong Kong' for a period of four years at a fee of $25,000 per month.

19. The Purported March 2000 Minutes purported to be minutes of a meeting of directors of the appellant held on 31 March 2000. The Owner and his mother were recorded as the only persons present at the meeting.

20. The Owner told us that the Purported April 2000 Agreement was signed by him on behalf of the appellant and by his mother on behalf the Alleged Service Provider and that she signed it around April 2000.

21. When asked about management fee for the last of the five years of assessment, the Owner produced a copy of what purported to be an agreement dated 1 April 2004 made between the appellant and the Alleged Service Provider ('the Purported April 2004 Agreement'). The only material difference from the Purported April 2000 Agreement was the amount of monthly fee. It became $15,000.

22. The Owner was evasive on the dates of appointment of her mother as a director of the appellant and of the Alleged Service Provider. We drew the Owner's attention to the Revenue's

case on the Purported April 2000 Agreement and on the disallowance of the alleged management fee. The Owner started by alleging that this was the first time that he knew about the point, then apologised for what he described in his own words as 'manipulation of the time', said he had to 'surrender' and referred to 'a number of very dishonest accountants':

> 'Mr Shum: ... The point is, if you look at page 23 of the B1 bundle, the evidential weight to be given to this contract [the Purported April 2000 Agreement] is –
>
> [The Owner]: I know you are trying to say the date does not match.
>
> Mr Shum: That is the point, so how are you going to deal with that point?
>
> [The Owner]: That is the first time I know now.
>
> Chairman: That is not the first time. That is the reason given by the acting deputy commissioner and that is what you are appealing against. It is not something that the assessor here springs on you.
>
> [The Owner]: These things I have to apologise. I think this is a great fault. It shows that this is, what do you call it, manipulation of the time not in accordance to the actual happening, you know. I see this and I have to surrender.
>
> Mr Shum: That is right, but you have to persuade us that –
>
> [The Owner]: I so regret that I had a number of very dishonest accountants.'

23. The Owner made no attempt to deal with the Revenue's arguments that the Purported April 2000 Agreement and the purported March 2000 Minutes were created after the event and tried to shift his grounds by saying that:

> 'My point is still based on as I mentioned just now, the rental, if the management fee is not appropriate, then the rental is also not applicable.'

24. His attention was drawn to section 66(3) of the Inland Revenue Ordinance, Chapter 112, and to the appellant's grounds of appeal. The hearing was stood down to give him time to consider the way forward and to formulate the ground(s) of appeal if he wished to apply for consent under section 66(3).

25. After the adjournment, he applied for our consent to rely on the following additional ground of appeal:

'Based on rental rate which declined in the year 1999, it worked out as follows. [The tenant of one of the units] reduced $16,600 per month to $12,000 after a series of negotiation, comparing with [the Alleged Service Provider] was at $38,500 per month, reduced by 28% similar to the above will be around $27,000 per month.'

26. Mr Fung Chi-keung opposed the application.

27. After hearing both parties, we announced our decision declining to give our consent and told the parties that our reasons would be given in our decision on the appeal.

28. Neither party called any witness.

Board's reasons for decision refusing consent to rely on a further ground

29. Section 66 provides that:

'(1) Any person (hereinafter referred to as the appellant) who has validly objected to an assessment but with whom the Commissioner in considering the objection has failed to agree may ... either himself or by his authorized representative give notice of appeal to the Board; but no such notice shall be entertained unless it is given in writing to the clerk to the Board and is accompanied by a copy of the Commissioner's written determination together with a copy of the reasons therefor and of the statement of facts and a statement of the grounds of appeal.

(1A) ...

(2) The appellant shall at the same time as he gives notice of appeal to the Board serve on the Commissioner a copy of such notice and of the statement of the grounds of appeal.

(3) Save with the consent of the Board and on such terms as the Board may determine, an appellant may not at the hearing of his appeal rely on any grounds of appeal other than the grounds contained in his statement of grounds of appeal given in accordance with subsection (1).'

30. It is clear from the original grounds of appeal that they were confined to the issue of deductibility of the alleged management fee. The issue of rental income was plainly not in issue. It was raised for the first time at the hearing when the Owner was attempting to dodge the issue of the authenticity of the Purported April 2000 Agreement and the Purported March 2000 Minutes.

Unless we gave our consent, the appellant was precluded by section 66(3) from raising the question of rental income or from relying on the proposed further ground.

31. In Hebei Enterprises Limited and others v Livasiri & Co (a firm) and others, HCA 20094/1998, 3 June 2004, unreported, Deputy Judge Poon (as he then was), in giving reasons for having dismissed an application to amend the pleadings, began by stating the applicable principles. These include the following. The proposed amendment must be sufficiently intelligible. It is incumbent on the party seeking amendment to ensure adequate particularity. It is no answer to an objection that a proposed amendment lacks particulars, to say that particulars can be given later. This is particularly so in the case of late amendments. See paragraphs 3 – 10 of the Reasons for Decision and the cases there cited.

32. We considered that these principles were equally applicable to an application under section 66(3), especially in respect of late applications.

33. That the proposed further ground was unintelligible is not capable of much elaboration.

34. Ground i) of the original grounds of appeal referred to rental income from a 'third party' and the Alleged Service Provider and asserted that rental 'was at market rate'. The proposed further ground did not sit comfortably with this assertion.

35. There was no allegation of the date when the alleged reduction to $12,000 took place.

36. The proposed further ground dealt only with the rental of the Alleged Service Provider (alleged to be $38,500 per month) and was silent on the rental of the Third Company.

37. The proposed further ground was silent on the period for a similar 28% reduction.

38. On the copy tenancy agreements produced by the appellant at the hearing of the appeal, the monthly rental for three units from 1 August 1998 to 31 July 2002 and for four units from 1 August 2002 to 31 July 2004 had always been $36,000. For the two year period from 1 August 2002 to 31 July 2004, the Alleged Service Provider and the Third Company enjoyed a reduction in rental in that they were renting one more unit at the same rental.

39. The appellant's audited financial statement showed the following as rental income from the Alleged Service Provider and the Third Company:

	1997/98	**1998/99**	**1999/2000**	**2000/01**	**2001/02**	**2002/03**	**2003/04**	**2004/05**
	$	$	$	$	$	$	$	$
Rental income	661,200	641,200	589,800	576,000	468.000	432,000	432,000	360,000
Rental income	462,000	442,000	432,000	360,000	297,000	216,000	216,000	252,000

from the Alleged Service Provider								
Rental income from the Third Company				72,000	135,000	216,000	216,000	252,000

40. The fact that the rental of one tenant was reduced did not mean that a corresponding reduction for another tenant must necessarily follow.

41. More importantly, the amount of rental income was a question of fact. There was no allegation that the rental income for any of the five years which we are concerned with was in fact less than what the appellant reported in its tax returns. To argue that the Alleged Service Provider could or should have asked for and been given a reduction would not get the appellant anywhere in the absence of any allegation that the Alleged Service Provider' s rental had in fact been reduced to amounts less than those reported in the tax returns.

42. The contention that the Owner could have decided not to charge the Alleged Service Provider and the Third Company any rental, or could have decided to charge a lower rental, and thus achieve the same result as incurring a management fee was obviously unsustainable. None of the assessments appealed against was incorrect or excessive merely because the appellant could have chosen, but chose not, to conduct the related party transactions in a different manner. The appellant chose to charge the Alleged Service Provider and the Third Company the amounts of rental reported. The assessor was perfectly at liberty to accept the income as reported and assess accordingly.

43. In considering whether to allow the appellant to rely on the proposed further ground, we bore in mind the prejudice which the respondent might suffer. The amounts of the appellant' s rental income had never been in issue before the hearing of this appeal. Had rental income been in issue, the respondent could and should have wished to investigate the tax affairs of the companies owned by the Owner. The respondent had had no opportunity to make these investigations before the hearing of the appeal. If the rental income of the appellant should be reduced, the respondent would probably wish to reduce the amounts of rental expenditure of the Alleged Service Provider and the Third Company in computing their profits. The respondent might be precluded by the six year time limit under section 60 from doing so.

44. The proposed further ground was unintelligible, devoid of material particulars, plainly unarguable and was prejudicial to the respondent.

45. In the exercise of our discretion, we declined to allow the appellant to rely on the proposed further ground.

Authenticity of the Purported Agreements and the Purported Minutes

46. The appellant put forth and relied on the following documents in support of its claim for deduction of management fee:

(a) the Purported March 2000 Minutes;

(b) the Purported April 2000 Agreement; and

(c) the Purported April 2004 Agreement.

47. The Owner's mother was not appointed a director of the appellant until 23 April 2003. She could not possibly have attended as a director of the appellant on 31 March 2000 as allegedly recorded in the Purported March 2000 Minutes.

48. The Owner's mother was not appointed a director of the Alleged Service Provider until 1 December 2001. She could not possibly have signed in April 2000 as a director of the Alleged Service Provider on the Purported April 2000 Agreement.

49. As noted above, Schedule 7 to the audited financial statements for 2000/01 described the management fee as 'fee on provision of office supplies & accounting and management services for the year'. Provision of office supplies was not mentioned in the Purported April 2000 Agreement. If the Purported April 2000 Agreement had come into existence on about 1 April 2000, there was no reason why the description of the fee in the audited financial statement should be different from the terms of the agreement.

50. Not only did the Owner not challenge the Acting Deputy Commissioner's view that these two documents were not contemporaneous, he recognised that there was 'manipulation of the time' and alleged that he had 'a number of very dishonest accountants'.

51. In our decision, these two documents were not contemporaneous, not authentic and were made up afterwards to support the claim for deduction. We attach no weight to either of them.

52. Given our findings on the Purported March 2000 Minutes and the Purported April 2000 Agreement, we view the Purported April 2004 Agreement with suspicion. There was no explanation why it had not been produced earlier. There was no explanation for the reduction of the service fee from $25,000 to $15,000 per month. The four units were sold in February 2005. There was no explanation why service fee for March 2005 had not been reduced. We are not satisfied on a balance of probabilities that the Purported April 2004 Agreement was contemporaneous or authentic. We attach no weight to it.

Board's decision on deduction of management fee

53. Section 68(4) provides that the onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.

54. Section 16(1) provides for deduction of all outgoings and expenses to the extent to which they were incurred during the basis period by the appellant in the production of profits in respect of which it was chargeable to profits tax for any period. By virtue of section 17(1)(a), no deduction shall be allowed in respect of domestic or private expenses.

55. Whether or not the appellant did incur the alleged expenses; whether or not the alleged expenses were incurred during the basis period and whether or not the alleged expenses were incurred in the production of profits are questions of fact. The onus is on the appellant.

56. There is no oral evidence, whether on the incurrence of the expense, on the services covered by the expense, on the reason(s) for omission to charge management fee in its audited financial statements for 2001/02, or at all.

57. There is no explanation for the fluctuation of the management fee from $186,000 in 1997/98, $24,000 in 1998/99, nil in 1999/2000, $300,000 in 2000/01 – 2003/04, to $180,000 in 2004/05.

58. There is no explanation why no management fee from the appellant was disclosed by the Alleged Service Provider under related party transactions for 2000/01 and 2001/02.

59. We are not satisfied on a balance of probabilities that the appellant had incurred any management fee in 2000/01 – 2004/05. The appellant has failed to establish the factual basis for deduction and the appeal must be dismissed.

Disposition

60. We dismiss the appeal and confirm the assessments appealed against as increased by the Acting Deputy Commissioner.

Referring papers to the Secretary of Justice

61. In view of our finding that the Purported March 2000 Minutes and the Purported April 2000 Agreement were not contemporaneous and were not authentic, we have given serious consideration to referring the papers to the Secretary of Justice.

62. We have decided not to do so in this case. We must, however, warn that the need to protect and preserve the integrity and fairness of the tax appeal process may require the Board to refer the papers to the Secretary of Justice in future.

Costs order

63. We deprecate the appellant for putting forward and relying on documents which are not authentic, knowing that they were tainted by 'manipulation' and 'serious dishonesty'.

64. The Owner claimed that he had not read the appeal bundles. To pursue an appeal without having read the papers, as the appellant has done in this case, was bound to waste the Board' s time and resources.

65. The appellant persisted in pursuing this hopeless appeal after realising that it 'had to surrender'.

66. We are of the opinion that this appeal is a bad case of abuse of the process. Pursuant to section 68(9), we order the appellant to pay the sum of $4,000 as costs of the Board, which $4,000 shall be added to the tax charged and recovered therewith.

Postscript

67. There were numerous gaps in the disclosure of documents by Mr Fung Chi-keung and much time was wasted by the Board trying to find information or documents (including those referred to in the Determination) which were not there.

68. Authorities are different in nature from documents and should be separately listed.