

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D32/93

Profits tax – theatrical performer – what expenses can be deducted - section 16(1) of the Inland Revenue Ordinance.

Panel: Ronny Wong Fook Hum QC (chairman), Ng Yin Nam and Archie William Parnell.

Dates of hearing: 6, 7 and 8 September 1993.

Date of decision: 3 November 1993.

The taxpayer was a theatrical performer who contracted with a company to pay all of his income to the company as management fees. The management company was of a private personal nature employing relatives of the taxpayer. The Commissioner refused to allow the management fee to be deducted for profits tax purposes and also refused to allow the taxpayer to deduct the expenses incurred by the management company. The taxpayer appealed to the Board of Review.

Held:

The Commissioner was correct in refusing to allow the taxpayer to deduct the management fee from his income assessable to profits tax. So far as the expenses of the management company were concerned the majority were of a personal nature. After analyzing the expenses the Board allowed some to be deducted as being outgoings and expenses incurred in the production of the taxable profits.

Appeal allowed in part.

S P Barns for the Commissioner of Inland Revenue.

Edwin Chiu Ngar Wing of T C Ng & Co for the taxpayer.

Decision:

I. BACKGROUND OF THIS CASE

1. A Limited ['A Ltd'] is a company incorporated in Hong Kong in early 1984. According to its annual return for 1986, its business address was in Place X. Its issued share capital was 10,000 shares of \$1 each registered in the respective

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names of the Taxpayer (9,999 shares) and his sister Miss A (1 share). Both of them gave their address in Place Y.

2. A Ltd reported to the Revenue for profits tax. Its assessment for the year of assessment 1985/86 was finalised and A Ltd duly paid tax levied on it. For the year of assessment 1986/87 A Ltd reported to the Revenue 'Income' by way of 'Performance Fee' in the sum of \$1,053,689.57. By a letter dated 27 April 1989, the Revenue sought from Messrs T C Ng & Co ['the representative'] an analysis in respect of this head of income. This train of inquiry led to the eventual disclosure by the representative on 27 March 1990 of an agreement between A Ltd and the Taxpayer ['the 1984 agreement'].
3. The 1984 agreement was for 'the period of five years commencing from September 1984 and ending in December 1988'. It provided for the appointment of A Ltd as the Taxpayer's 'Sole Manager' in all matters related to the Taxpayer's 'engagement in his performance'. It further provided:
 - (a) By clause (B):

'The Manager will be responsible for:

 - (i) The negotiation of all contracts relating to the [Taxpayer's] engagement ...
 - (ii) The marketing of the [Taxpayer's] services and engagement ...
 - (iii) The maintenance of the [Taxpayer's] image ...
 - (iv) The document and handling of all papers pertaining to the [Taxpayer's] performances.
 - (v) Counselling the [Taxpayer] in dealing with his personal affairs that will hinder his performances. However, expenses relating to the personal services will be the responsibility of the [Taxpayer].'
 - (b) By clause (C) that A Ltd 'will be paid a fee by the [Taxpayer] equivalent to 100% of the [Taxpayer's] total income derived from services outlined above. The management fee has to be settled by the [Taxpayer] upon received (sic) full payment of each services outlined above'.
 - (c) By clause (D) that 'All performances required by the [Taxpayer] that are not services provided generally by [A Ltd] such as legal and auditing fees will be borne by the [Taxpayer]'.
 - (d) By clause (G) that '[A Ltd] will be paid for the [Taxpayer's] all expenses which is including the taxation, general expenses (such as: entertainment

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fee, transportation fee and all miscellaneous expenses). And all the expenses will be deducted from income of the performer’.

- (e) By clause (H) that the Taxpayer ‘has the full right to sign any contracts by himself and also to receive any payment or settlement on behalf of [A Ltd]’.
4. Because of the disclosure of the 1984 agreement, the Revenue took the view that the sums of \$603,929 reported as ‘Production Fee’ and \$1,053,689.57 reported as ‘Performance Fee’ in the accounts of A Ltd for the years of assessment 1985/86 and 1986/87 should be assessed in the name of the Taxpayer rather than A Ltd. Those sums were payments made for the services of the Taxpayer. By letter dated 28 February 1992, the Revenue further sought particulars of the various heads of ‘General and Administration Expenses’ listed in those accounts of A Ltd. Two reminders from the Revenue (18 May 1992 and 26 June 1992) were ignored. It was only by letter dated 31 August 1993 that the representative sought to give some particulars for the year of assessment 1986/87 intimating also that ‘The information for 1985/86 ... is not available ...’.
5. By his determination dated 5 May 1993, the Deputy Commissioner held that
- (a) ‘It is clear that all the contracts (except one) were entered personally by the Taxpayer. The income derived therefrom should therefore be the Taxpayer’s income and not A Ltd’s.’
 - (b) ‘Despite repeated requests, the Taxpayer did not supply further information or evidence to substantiate his deduction claims ... I am therefore not satisfied that the “Management fee” was an outgoing or expense incurred in terms of section 16(1) of the Inland Revenue Ordinance.’
6. The Taxpayer appealed against the determination of the Deputy Commissioner. By his ‘statement of grounds of appeal’ the Taxpayer raised two issues:
- (a) Whether ‘the performance fee is incorrectly assessed under the name of the [Taxpayer]’ and
 - (b) Whether ‘the assessable income, even if assessed in the name of the [Taxpayer], is excessive’.

II. WAS THE TAXPAYER CORRECTLY ASSESSED?

1. We have no doubt at all that he was. This is not a case where a performer contracts to render his services exclusively to a management company in return

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for a fee payable to him by the management company and the management company thereafter hires out his services to the public. The essence of the 1984 agreement was the Taxpayer's engagement of A Ltd as his sole manager. A Ltd was to be paid a fee by the Taxpayer. The fact that the fee payable by the Taxpayer to A Ltd was to mirror-image the fees earned by the Taxpayer under contracts that he made with third parties did not render the latter set of fees income of A Ltd.

2. All the contracts with third parties except one were made in the name of the Taxpayer. The one exception related to a contract concluded in April 1985 between B Ltd and A Ltd (agent for the [Taxpayer]). We take the view that this is not a true exception. A Ltd was merely contracting for and on behalf of the Taxpayer. Our views have the support of clause 11 of this contract that referred to 'his own arrangements ... at his own expenses'.

III. DEDUCTIBILITY OF THE MANAGEMENT FEE

1. The Taxpayer gave evidence before us. He gave the following reasons for the appointment of A Ltd as his manager:
 - (a) 'If the middleman was powerful and influential, then the middleman is capable of pushing up the performer.'
 - (b) 'The performer do not wish to be directly involved in the negotiations.'
 - (c) 'The performer will find himself being left no room for manoeuvring when discussing over the prices, that is to say a middleman will act ... like a buffer ...'
 - (d) 'A manager will always remind the performer as to what is the right thing for him to do ...'
2. We attach no weight to the reasons so furnished by the Taxpayer as to the appointment of A Ltd. As pointed out above, all the contracts (save one) that produced the income in question were in the Taxpayer's personal name. A letter produced by the Taxpayer from C Ltd indicates that it 'was [their] company's policy to sign all agreements directly with the performer'. A Ltd was incorporated in early 1984. It did not have a track record of managerial skill or acumen when the 1984 agreement was signed. Up to the date of the hearing before us, A Ltd failed to secure the service of any performer other than the Taxpayer under its banner.
3. The services said to have been rendered by A Ltd to the Taxpayer were imprecise and unclear. Most of A Ltd's alleged staff consisted of the Taxpayer and his close relatives. None of them possessed any managerial experience or qualification. The justification given by the

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Taxpayer for the payment of 100% of his performance fees to A Ltd was that he himself was ‘the beneficial owner of nearly 100% of the shares of A Ltd ...’. In these circumstances we are of the opinion that a significant, if not dominant, purpose of the arrangement was to minimise the personal tax liability of the Taxpayer.

4. The Revenue did not place any reliance on section 61 of the Inland Revenue Ordinance. Both the Revenue and the representative cited for our consideration D61/91, IRBRD, vol 6, 457. We respectfully adopt the following principles established in that decision:
 - (a) The ‘wholly and exclusively’ test is not appropriate for determining whether the expenses in question can be deducted for profits tax purposes.
 - (b) ‘Section 16(1) of the Inland Revenue Ordinance states that the outgoings and expenses are deductible “to the extent” to which they are incurred in the production of taxable profits. The three words which we have quoted make it clear that each outgoing and expense must be looked at and analyzed to find out to what extent it was incurred to produce the profit. What we must decide is the cost to the practice of the services provided.’

5. The representative argued that the full management fee representing 100% of the Taxpayer’s earnings is deductible. Little justification was given for adopting this approach. It was left to the Revenue to examine with the Taxpayer each item of ‘General and Administrative Expenses’ set out in A Ltd’s accounts in order to decide the services provided by A Ltd; the costs of such services and whether the item in question was incurred for the production of the fees of the Taxpayer.

6. The Profit and Loss Account of A Ltd for 1985 and 1986 can be summarised as follows:

<u>Description</u> <u>1985</u>	<u>Amount</u> \$	<u>Description</u> <u>1986</u>	<u>Amount</u> \$
Income		Income	
Production fee	603,929		
Interest received	4,318.6		
		Performance Fee	1,053,689.57

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Total	608,247.6	Total	1,053,689.57
Expenses			
Salaries and Allowances	39,755	Staff Salaries	182,800
Rent & Rates	63,646.33	Rent & Rates	20,794.88
Building Management Fee	800		
Electricity	473.5	Water, Gas and Electricity	2,059.5
Telephone	1,599.5	Telephone and Telex	179
Costumes & Clothes	62,452.58	Costumes & Clothes	71,810.25
Consultation & Medicine	3,086.6	Consultation & Medicine	8,177.17
Manager & Adviser's Remuneration	14,000		
Fee for Supporting Performers	55,555	Fee for Other Performers	89,550
Commission Paid	2,500		
Motor Car Expenses	65,391.8	Motor Car Expenses	29,555.72
Entertainment	88,872.89	Entertainment	91,789.76
Messing	2,671	Messing and Allowance	79,028.78
Overseas	47,727.81	Overseas	88,379.43

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Travelling		Travelling Expenses	
Local Travelling	193.5	Local Travelling Expenses	24,976
Repair & Maintenance	5,668.1	Repair and Maintenance	22,979.3
Insurance	26,975.15	Insurance	6,821.6
Interest Paid	7,354.15		
Legal & Professional Fee	1,812.5	Professional Fee	10,697
Accountancy Fee	4,300	Accountancy Fee	2,000
Audit Fee	3,000	Audit Fee	3,500
Sundry Expenses	6,694	Sundry Expenses	7,854
Leasing Charges	23,749.5		
Loss on Disposal of Fixed Assets	28,551		
Depreciation	14,980.62	Depreciation on Furniture and Fixtures; Motor Vehicles and Musical Equipment	50,419.25
		Handling and Service Charges	6,197.6
		Performance	201,330

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Production Fee

7. Salaries and Allowance [\$39,755 for 1985 and \$182,800 for 1986]:

- (a) The representative by their letter of 31 August 1993 furnished the following particulars in respect of the sum of \$182,800 for 1986:

<u>Recipient</u>	<u>Position</u>	<u>Amount</u> \$	<u>Address</u>
Mr A	Director	28,000	Place Y
The Taxpayer	Performer	30,000	Place Y
Miss B	Secretary	28,800	Not available
Miss C	Junior Clerk	19,200	Not available
Ms D	Amah	28,000	Place Y
Miss E	Hair Stylist	28,000	Place Y
Miss F	Junior Clerk	20,800	Place Y

Cross-examination revealed that Mr A is the father, Ms D is the mother and Miss E is the younger sister of the Taxpayer. The father had allegedly 'taken care of me and also protected my image'. The mother had allegedly 'taken care of me because she is my mother'. The younger sister was about eighteen or nineteen in the year of assessment 1985/86 and she was a qualified hair stylist. Apart from her younger sister, the Taxpayer also used the service of other hair stylists. No evidence was given as to the precise duties of the other employees and how their services contributed towards production of the Taxpayer's income.

- (b) The alleged salary paid to the Taxpayer had not been included in his salaries tax returns for the relevant years. Not a single receipt had been produced before us in support of the payment of the sums in question to all the alleged recipients.
- (c) We are not satisfied that any of these sums is deductible from the earnings of the Taxpayer.

8. Rent and Rates [\$63,646.33 for 1985 and \$20,794.88 for 1986]:

- (a) The Taxpayer did not produce any tenancy agreement or rent receipt for our consideration. The breakdown for 1985 indicates that the sum of \$63,646.33 was incurred as follows:

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- (i) \$60,000 in respect of a premises in Place P occupied by the Taxpayer's girl friend.
- (ii) \$561.33 in respect of rates of an unidentified premises.
- (iii) \$3,085 said to be 'rental for performance venue'.

We are of the view that only \$3,085 is deductible as expense incurred in the production of the Taxpayer's profits.

- (b) The general tenor of the Taxpayer's evidence for 1986 is that the sum in question relates to A Ltd's occupation of Place X. We have referred in paragraph I.1 above to Place X being the business address of A Ltd. On balance of probabilities, we are not persuaded that this sum was related in any way to the production of the Taxpayer's earnings.
- (c) The Taxpayer asserted that his residential address was at Place Y and that Place X 'was for the use of A Ltd and was not subject to private use'. No convincing explanation was given as to why the telephone line at Place X was 'residential' as opposed to 'business' line. The Taxpayer also said in evidence that:
 - (i) '... before I rent Place X, it was not for the office but later we found that this is very good for an office and the owner, they promised, they said, "You can use as residential usage and also for office usage". And so that is how our office was established there.'
 - (ii) '... in 1986 and 1987, we moved to another office, ... but we remained in Place X for our residential usage ...'
- (d) As a result of the representative's letter of 31 August 1993, the Revenue inspected some of the vouchers disclosed to them for the first time. Two of those vouchers are revealing:
 - (i) A voucher dated 18 September 1985 from D Ltd addressed to the Taxpayer personally for the purchase of lamps, television and launderette.
 - (ii) A voucher dated 7 October 1985 from E Ltd indicates that two beds and one mattress were sent to Place X.
- (e) We are of the view that Place X was the Taxpayer's private residence and the sum for 1986 is not deductible.

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9. Building Management Fee [\$800 for 1985 only]:
- (a) No evidence was adduced to explain this item.
 - (b) We are not satisfied that it is deductible.
10. Water, Gas and Electricity [\$473.5 for 1985 and \$2,059.5 for 1986]:
- (a) No explanation was given to us in respect of these figures. We assume that these were in respect of occupation of Place X.
 - (b) Given our views on the nature of that occupation, we are of opinion that these items are not deductible.
11. Telephone and Telex [\$1,599.5 for 1985 and \$179 for 1986]:
- (a) We have referred in paragraph III.8.(c) above to the nature of the telephone line involved.
 - (b) The Taxpayer made no effort to explain the nature of the use of the telex. We are not disposed to draw any inference in his favour given the general theme of his case.
12. Costumes and Clothes [\$62,452.58 for 1985 and \$71,810.25 for 1986]:
- (a) The Taxpayer produced for our inspection sample garments said to have been used in the course of his performances. We are satisfied that these articles were purchased for use by the Taxpayer for his services.
 - (b) The Revenue however produced several sample invoices issued by fashionable outlets said by the Taxpayer to be attributable to purchases of clothing and shoes. We are not satisfied that these items were in any way related to the production of the Taxpayer's earnings.
 - (c) In the absence of any detailed break-down of the figures, we have to do the best we can. By virtue of the evidence referred to above, we accept that sums were incurred for costumes fit only for use by the Taxpayer in his performances. We conclude that 50% of the two figures in question [\$31,226.29 for 1985 and \$35,905.13 for 1986] are deductible.
13. Consultation and Medicine [\$3,086.6 for 1985 and \$8,177.17 for 1986]:
- (a) The Taxpayer gave the following explanations:

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‘To provide good performances, I want to keep good health, so I go to consult the doctor before and after the performance and also sometimes if I get a cold, I go to their clinic.’

- (b) We accept that it is important for the performer to have good health prior to his performances but we do not accept that treatment for his ordinary cold can be said to be related to production of his earnings. Once again, doing the best we can, we would allow 50% of the two sums [\$1,543.3 for 1985 and \$4,088.59 for 1986].

14. Manager & Adviser’s Remuneration [\$14,000 for 1985]:

- (a) We have no evidence as to the reason or purport of this sum.
- (b) We allow no deduction for the same.

15. Fee for Supporting Performers [\$55,555 for 1985 and \$89,550 for 1986]:

- (a) The contracts signed between the Taxpayer and those who employ his performances imposed obligations on the Taxpayer to provide service of supporting performers for his performances.
- (b) We are of the view that both sums are deductible as the same were incurred to produce the Taxpayer’s profits.

16. Commission Paid [\$2,500 for 1985]:

- (a) The Taxpayer gave us no explanation for this figure.
- (b) The same is not deductible.

17. Motor Car Expenses [\$65,391.8 for 1985 and \$29,555.72 for 1986] and Repairs and Maintenance [\$5,668.1 for 1985 and \$22,979.3 for 1986]:

- (a) We have seen some of the receipts in respect of these items. They relate to repairs effected to a car driven by the Taxpayer. All the receipts were in the name of the Taxpayer as opposed to A Ltd. The Taxpayer explained that mistakes might have been committed as A Ltd was unknown to the garages. The representative further sought to justify the same as essential to the ‘image’ of the Taxpayer.
- (b) We are of the view that these items are not deductible. They are merely personal expenses of the Taxpayer wholly unrelated to the production of the profits in question.

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18. Entertainment [\$88,872.89 for 1985 and \$91,789.76 for 1986] and Messing [\$2,671 for 1985 and \$79,028.78 for 1986]:

- (a) We have seen some of the receipts in respect of these items. The following are examples:
 - (i) A receipt dated 4 May 1985 issued by F Ltd for \$200 in respect of sauna and massage enjoyed by the Taxpayer.
 - (ii) A receipt dated 4 July 1985 issued by G Ltd for the billiard game played by the Taxpayer.
 - (iii) Credit card coupons signed by the girl friend of the Taxpayer in respect of her food and clothing.
- (b) We have considered a diary produced by the Taxpayer for the year 1993. That diary sheds little light on the nature of these expenditures incurred by the Taxpayer in the year of assessment 1985/86.
- (c) We have no doubt that these items are not deductible. We are of the further view that the nature of these receipts casts a very dim light on the Taxpayer's case as a whole.

19. Overseas Travelling [\$47,727.81 for 1985 and \$88,379.43 for 1986] and Local Travelling [\$193.5 for 1985 and \$24,976 for 1986]:

- (a) By letter dated 9 June 1989, the representative informed the Revenue that 'The overseas trips were business trips. Some trips were the free passage allowance granted to the director. The other trips were for recreational purpose of the director'.
- (b) By their letter of 31 August 1993, the representative explained to the Revenue that in respect of the sum of \$24,976 said to be local travelling for 1986. 'There was a classification error of \$24,817 of trip expenses to Asia included in local travelling expenses. The trips were for business purpose.'
- (c) Apart from these and other bare assertions of the Taxpayer, we have no other evidence that helps to elucidate the true nature of these expenditure. We are of the view that the Taxpayer has failed to discharge his onus and these sums are not deductible.

20. Insurance [\$26,975.25 for 1985 and \$6,821.6 for 1986]:

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(a) The Taxpayer told us that the sum for 1985 was in respect of his own life insurance and the sum for 1986 was in respect of insurance for his motor car.

(b) We see no possible basis for allowing these deductions.

21. Interest Paid [\$7,354.15 for 1985]:

(a) The Taxpayer furnished no information regarding this item.

(b) No allowance can be made for it.

22. Legal and Professional Fee [\$1,812.5 for 1985 and \$10,697 for 1986]:

(a) In their letter of 31 August 1993, the representative explained that:

(i) 'The claim was against Newspaper X for the defence of the image of the Taxpayer.'

(ii) 'The other expenses were incurred for the preparation of the lease agreement of the company's office premises and the preparation of certain contracts.'

(b) No further evidence was adduced before us pertaining to the litigation with Newspaper X. The assertion of 'the lease agreement of the company's office premises' is inconsistent with the Taxpayer's evidence before us that 'before I rent Place X, it was not for the office' [emphasis applied]. We have seen some of the contracts. We do not see any performer involvement in the preparation of those contracts.

(c) Accordingly, we would not allow any deduction in respect of these sums.

23. Accountancy Fee [\$4,300 for 1985 and \$2,000 for 1986] and Audit Fee [\$3,000 for 1985 and \$3,500 for 1986]:

(a) The Revenue made no challenge of these items.

(b) Although we have our reservations about these items, we are not prepared to disturb the concession by the Revenue.

24. Sundry Expenses [\$6,694 for 1985 and \$7,854 for 1986]:

(a) The break-down for 1985 indicates that \$6,694 was spent on 'Health Membership Fee; Cable & Wireless; Stationery; Business Registration Fee; Tuition Fee; Glass; Photo Copy; Refreshment; Bag; Paging Fee; Flower and Transportation'.

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- (b) We are not satisfied that any of these items is related to the production of the Taxpayer's profits as opposed to his personal expenditure.

25. Leasing Charges [\$23,749.5 for 1985]:

- (a) This was incurred for leasing of a car said by the Taxpayer to be essential for his image.
- (b) We are of the opinion that this item was no more than a personal expenditure of the Taxpayer. We would disallow any deduction therefor.

26. Loss on Disposal of Fixed Assets [\$28,551 for 1985]:

- (a) The Taxpayer made no attempt to justify why this sum should be deducted.
- (b) We make no allowance for the same.

27. Depreciation on Furniture and Fixtures; Motor Vehicles and Instrument [\$14,980.62 for 1985 and \$50,419.25 for 1986]:

- (a) We reject any claim in respect of furniture/fixtures and motor vehicles. We are of the opinion that the same are not related to the production of the Taxpayer's profits.
- (b) The Taxpayer explained that the instrument was for the production of his performances. We accept this evidence. We would allow a deduction of \$9,135.8 for 1985. No separate breakdown was given for 1986. On that basis, the Taxpayer failed to discharge his burden. No allowance can therefore be made for 1986.

28. Handling and Service Charge [\$6,197.6 for 1986]:

- (a) The Taxpayer gave us no assistance on this figure.
- (b) We cannot give him any allowance in respect of the same.

29. Performance Production Fee [\$210,330 for 1986]:

- (a) By letter dated 27 March 1990, the representative informed the Revenue that this sum was paid to one I Ltd which was responsible for the 'design and co-ordination work' for the performances in venue X. The representative further submitted the audited accounts of I Ltd for 30

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April 1986 and a receipt issued by that company dated 18 March 1986 for \$201,330.

- (b) The Taxpayer was one of the directors of I Ltd. The audited account of I Ltd recorded the receipt of the sum of \$210,330. It further recorded I Ltd various sums for certain expenses. To a certain extent, these items duplicate similar items referred to above.
- (c) We have carefully considered this item and come to the view that we should regard the same as confined to the services in venue X whilst the preceding items were attributable to performances elsewhere. We would therefore allow this item in full.

IV. OUR DECISION

1. The Taxpayer is correctly assessed for 1985 and 1986 as follows:

<u>YEAR</u>	<u>1985/86</u>	<u>1986/87</u>
	\$	\$
AMOUNT	603,929	1,053,689

2. We allow the following deductions:

<u>NATURE OF ITEM</u>	<u>1985/86</u>	<u>1986/87</u>
	\$	\$
Rental for Performance Venue	3,085	
Costumes & Clothes	31,226.29	35,905.13
Consultation and Medicine	1,543.3	4,088.59
Fee for Other Performers	55,555	89,550
Accountancy Fee	4,300	2,000
Audit Fee	3,000	3,500
Depreciation for Instrument	9,135.8	
Performance	<u> </u>	<u>210,330</u>

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Production Fee

Total	<u>\$107,845.39</u>	<u>\$345,373.72</u>
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3. We direct that the assessments be remitted back to the Deputy Commissioner to be reduced accordingly.