Case No. D32/94

Profits tax – professional practitioner – service company – management fees – sections 16 and 61 of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Michael Choy Wah Ying and Norman Ngai Wai Yiu.

Date of hearing: 28 April 1994.
Date of decision: 22 August 1994

The taxpayer was a medical practitioner who made use of a service company. Management fees claimed by the taxpayer were disallowed by the Commissioner who proposed to allow only part thereof on the authority of D61/91, IRBRD, vol 6, 457. At the hearing of the appeal the taxpayer argued that the service fee was not capable of being divided into its component parts. This submission was accepted by the Board which indicated a likelihood that it would disallow the entirely of the service fee because it did not fall within the meaning of section 16 of the Inland Revenue Ordinance.

The representative for the Commissioner indicated that it was the view of the assessor that the arrangement between the taxpayer and his service company was both artificial and fictitious. The taxpayer accepted that this was the case.

Held:

This was a case to which section 61 of the Inland Revenue Ordinance had application. The Board directed that the assessment against which the taxpayer had appealed should be remitted back to the Commissioner to assess the profit of the taxpayer on the basis that the service company and the service agreement were to be disregarded.

The Board noted that if the assessor had not invoked the provision of section 61 of the Inland Revenue Ordinance it is likely that the Board would have disallowed the entire amount of the management fees as not coming within the ambit of section 60 of the Inland Revenue Ordinance.

Appeal remitted to the Commissioner for re-assessment.

Case referred to:

D61/91, IRBRD, vol 6, 457

H Bale for the Commissioner of Inland Revenue.
K Y Yip for Messrs K Y Yip & Co for the taxpayer.

Decision:

This is an appeal by a taxpayer against two profits tax assessments for the years of assessment 1987/88 and 1988/89. The Taxpayer was a Medical Practitioner making use of a service company and certain expenses which he claimed to have incurred were disallowed by the Commissioner. The facts are as follows:

1. At all material times the Taxpayer was carrying on business as a medical practitioner.

2. In the absence of profits tax returns for the years of assessment 1987/88 and 1988/89 the assessor raised estimated profits tax assessments on the Taxpayer as follows:

	1987/88	1988/89
Estimated Net Assessable Profits	$150,000	$200,000
Tax Payable thereon	$24,750	$31,000

3. The Taxpayer objected to these estimated assessments and filed profits tax returns which disclosed the following relevant information:

	1987/88 $	1988/89 $
Period	1-4-1987 to 31-3-1988	1-4-1988 to 31-3-1989
Fee Income	650,613	1,414,030
Total Expenses (including Management Fees)	723,333 660,000	1,444,730 1,440,000)
Net Loss	($72,720)	($30,700)
Adjusted Loss per Return	($33,220)	($35,200)

4. The management fees claimed as deductions were payable to a service company owned and controlled by the Taxpayer and his relative. According to

the profits tax returns of the service company for the years of assessment 1987/88 and 1988/89 the following income and expenses were disclosed:

	1987/88 $	1988/89 $
INCOME		
Management Fees Received	660,000	1,440,000
LESS: EXPENSES		
Accounting	4,000	4,000
Auditor remuneration	6,000	6,000
Advertising	1,755	3,403
Bank charges and interest	148,355	165,781
Business registration fee	650	650
Cleaning Surgery	6,000	6,000
Dental Expenses	6,505	0
Depreciation	164,739	379,012
Electricity	4,837	5,644
Entertainment	52,000	63,263
Stationery	1,220	1,910
Hospital Fees (Miscellaneous)	17,896	21,476
Hospital Quarters	0	56,830
Insurance	1,350	3,482
Laboratory Fees	39,822	48,834
Local Travelling – Taxi	18,720	21,120
Building Management Fee	44,262	45,221
Maintenance and Repair	0	1,000
Medicine and Drugs	56,471	50,288
Messing	2,395	4,565
Motor Car Running Expenses	57,939	51,370
Newspaper and Magazines	307	259
Office Supplies	13,918	12,589

	1987/88 $	1988/89 $
Oversea Travelling	0	4,350
Paging	2,790	4,500
Postage and Stamps	50	550
Printing	34,407	16,743
Patient Rebate to Hospital/doctor	22,632	68,329
Rates	7,902	7,704
Staff Salary	52,875	66,624
Secretarial	480	400
Subscription	2,610	43,152
Telephone and Telecommunication	5,964	17,991
Education and Books	0	44,465
Uniform	4,148	15,162
	$782,999	$1,242,667
Net Profit/(Loss) For The Year	($122,999)	$197,333
Ajusted (Loss)/Profit per return	($441,073)	$989

5. The assessor made inquiries of the Taxpayer and on the basis of the information provided by the Taxpayer the assessor was of the opinion that certain expenses claimed by the service company appeared not to correspond to or reflect the services and facilities claimed to be provided to the Taxpayer, that certain expenses appeared to be domestic or private in nature and that certain expenses had not been incurred for the purpose of or in the production of the income of the Taxpayer's medical practice.

6. The Taxpayer's objection were referred to the Commissioner for his determination. When the matter was referred to the Commissioner the assessor made certain proposals, namely, that the assessable profits of the medical practice of the taxpayer for the years of assessment 1987/88 and 1988/89 should respectively be increased to $211,969 and $294,066. By his determination dated 19 November 1993 the Commissioner accepted the proposal made by the assessor and issued his determination accordingly. In his determination the Commissioner stated his reasons as follows:

‘(a) The issue for my determination in this case is whether the management fee purportedly incurred by the Taxpayer should be deducted in full in computing the Taxpayer's assessable profits.

(b) Section 16(1) of the Inland Revenue Ordinance (IRO) which deals with the deductibility of expenses for profits tax purposes states:

> “(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 under this part.”

For the purposes of ascertaining profits section 17(1) of the IRO prohibits the deduction of domestic or private expenses, including the cost of travelling between residence and place of business and the deduction of any expenditure of a capital nature.

(c) In this case the management company was to receive a fee from the Taxpayer for services and facilities it provided to the Taxpayer’s medical practice pursuant to a management agreement. The copy forwarded to the department is incomplete and not signed. The schedules to the agreement show that the facilities to be provided to the practice included office furniture, utility and accommodation, fax, telephone, typewriters and other medical equipment and apparatus and medical supplies. The services to be provided consisted of the company making available to the practice nurses, doctors, clerks, receptionist and other staff.

(d) What I have to decide therefore, is whether, in view of the nature of the expenses incurred by the company, the whole of the purported management fee incurred by the Taxpayer on behalf of his practice was incurred in the production of profits in respect of which the Taxpayer is chargeable to profits tax. I take this approach with the authority of a recent Hong Kong Board of Review decision, case No. D61/91, IRBRD, vol 6, 457. In that case, similar to the present case, the Board held that the management fee paid by a dentist to his management company could only be deducted to the extent that the fee related to the services (and facilities) provided to enable the taxpayer to earn the taxable profits. The Board considered that the fee should be adjusted for items of expenditure incurred by the management company that were domestic or private in nature. The Board was also of the opinion that although some expenses formed part of the management fee paid by the practice the expenses must be incurred for the purpose of earning the profits of the practice.

(e) With this in mind I am of the opinion that in the present case only part of the management fee was incurred by the Taxpayer in the production of the profits of the practice. It is apparent that certain expenses incurred by the company are domestic or private in nature or do not relate to the Taxpayer's medical practice. Unfortunately the company, of which the Taxpayer is a director, has not replied to the assessor's queries to ascertain exactly what proportion of the fee should be adjusted. Therefore I would be justified in disallowing the fee in its entirety. However, in the circumstances I agree with the adjustments proposed by the assessor.

(f) For the above reasons the objection fails and the assessments are revised as per the proposed assessable profits.'

7. The Taxpayer duly appealed to this Board of Review.

At the hearing of the appeal the tax representative appeared on behalf of the Taxpayer and made certain submissions. The main thrust of the submissions was that the fee paid by the Taxpayer to the service company was one lump sum fee which was indivisible and on the authority of D61/91, IRBRD, vol 6, 457 should be deducted in full.

The representative went on to submit in the alternative that the Board should also look at the items allegedly comprised in the fee and allow those which related to the earning of the profits of the medical practice and disallow those that did not.

The Board of Review pointed out to the representative for the Taxpayer, and to the Taxpayer himself who was present at the hearing that on the evidence before it, the Board would find as a fact that the service fees were indivisible fees. Therefore it would not be possible for the Board to consider the alternative ground of appeal. It was pointed out to the Taxpayer and his representative that having accepted their claim that the service fees were lump sum amounts which were indivisible then the Board would proceed to hear the case on that basis. The Board pointed out that if it could be established that the fees were incurred in the production of the taxable income then the entirety thereof would be deducted from the assessable profits but if on the other hand this could not be established then the entirety thereof would be disallowed. It was pointed out to the Taxpayer and his representative that it could well seriously prejudice the Taxpayer because if the Board were to find in favour of the Commissioner, the Taxpayer would be obliged to pay tax on his gross income without having the benefit of any expenses which if the service company did not exist would be clearly deductible by the Taxpayer in earning the income of the medical practice.

The Taxpayer informed the Board that he was not seeking to use the service company as a means of reducing his otherwise taxable income. He said that he only wished to claim those expenses which would have been deductible if they had been paid by him direct out of his medical practice.

The Board inquired of the Commissioner's representative whether or not it was the opinion of an assessor that section 61 of the IRO should apply to this case. The Commissioner's representative informed the Board that it was the view of an assessor that section 61 should apply, because the service company transactions were both artificial and fictitious.

The Taxpayer and his representative indicated to the Board that the Taxpayer accepted that section 61 of the IRO should apply to this case and that the alleged service agreement should be disregarded and that the medical practice operated by the Taxpayer should be taxed on the basis that the service company and the service agreement did not exist.

This Board was satisfied that on the submissions made by and on behalf of the Taxpayer and on behalf of the Commissioner it is right and proper that section 61 should be invoked.

Before proceeding further with this decision we place on record certain additional facts which were the basis on which we were able to find as a matter of fact that the fees would have been indivisible and that it is appropriate for the assessor to invoke section 61. These additional facts are as follows:

1. The Taxpayer was a medical specialist and carried on his medical practice together with his relative who was likewise a qualified medical practitioner.

2. The Taxpayer sought advice from his tax adviser who was a qualified accountant who advised that for various reasons it would be beneficial for the Taxpayer to set up a service company. Amongst a number of stated advantages were that the Taxpayer could purchase important assets in the name of a company so that they would be safeguarded in the event of negligence claims being made against the practice, that it would be easier to admit partners in the future, that third parties could be invited to invest in the service company even though they were non professionals, etc. (We do not comment on these stated advantages).

3. The Taxpayer himself said to the Board that there was really not much difference between the service company and the medical practice.

4. Having decided to set up the service company the Taxpayer and his relative discussed how to operate the same and how to issue invoices for the medical practice. They reached a verbal understanding or agreement and at some unknown time attempted to set this down in writing in the form of an agreement.

5. After operating for about two months there were a number of problems and in particular problems issuing invoices for the medical practice. The Taxpayer

sought advice from the tax adviser who recommended that a lump sum be paid by the practice to the service company.

6. The quantum of the service fee was decided by the Taxpayer on a somewhat arbitrary basis. He considered that a reasonable monthly income for a specialist with his skills working for a hospital should be $120,000 per month. He thought that this amount was too great for the first year of his practice and that the sum should be a little less. He then decided that $660,000 was an appropriate amount for the first year of the medical practice. Subsequently he felt that the full amount of $1,440,000 should be the appropriate amount. The Taxpayer explained that if his income exceeded $120,000 per month on average he would know that it was better to have his own medical practice than to work for a hospital.

7. The medical practice did not have its own bank account and used the bank account of the Taxpayer for the purposes of the medical practice. One reason for this was that if the service company had an overdraft it would be reduced when the receipts of the medical practice were paid into it.

8. There was a service agreement dated 1 April 1987 between the Taxpayer and the service company but it is not known when the same came into existence or was executed. An unsigned copy was provided to the Revenue before the determination of the Commissioner was issued. The signatures of the parties to the agreement were provided to the Revenue under cover of a letter dated 9 March 1994 sent by the tax representative and copied to the Board of Review.

9. Under cover of the same letter dated 9 March 1994, the tax representative also submitted to the Revenue and the Board of Review a copy of an undated purported amendment to the agreement dated 1 April 1987 which very fundamentally changed the terms of the agreement of 1 April 1987.

From the submissions and statements made to the Board and documents placed before the Board two things are quite clear. One is that the arrangement between the Taxpayer and the service company was a total sham. For all intents and purposes the medical practice and the service company were one and the same thing. A professional person who wishes to make use of a service company must realize that it is not something which he can turn on and off as he wishes. The service company and the medical practice must be kept at arms length and must operate independently and separately. Making use of a service company is expensive in both time and money and involves many matters of substance and not just formalities.

As the relationship between the Taxpayer and the service company was artificial and largely, if not totally, fictitious this is clearly a case which comes within the provisions of section 61.

In the case before us the Taxpayer is perhaps lucky that the representative for the Commissioner accepted the invitation of the Board in the course of the hearing to invoke the provisions of section 61. Had he not done so then this Board would have found that the sum paid to the service company was a lump sum fee which was indivisible. Having so decided it would then have been necessary for the Board to decide whether or not the fee was a deductible expense within the meaning of section 16 of the IRO. It is quite likely that this Board would have decided that it was not. It was necessary for the medical practice to incur certain expenses either directly or indirectly. The service company allegedly supplied services for a fee but that fee bore no relationship to the cost or quantum of the services. People in business who incur expenses which are excessive and bear little relationship to the production of the profits cannot expect to have the same allowed as expenses under section 16. If such expenses are divisible then they can be deducted 'to the extent to which they are incurred ... in the production' of the profits being assessed. D61/91 was an example of this. If they are not divisible then they should be disallowed in toto.

If section 61 had not been invoked it is likely that this appeal would have been a very salutary lesson for everyone involved with service companies. The Taxpayer may well have found himself in the position of paying profits tax on his gross medical practice income without the benefit of deductions which otherwise he could have made. The service company of course could have deducted some of the expenses claimed from its assessable profits but probably not all thereof. The balance of the fees would have been the taxable profit of the service company and would have been assessed as such.

The thinking of the tax representative was largely affected by the previous Board of Review decision cited to us, D61/91. In that case the Board decided that the service fee was not a lump sum service fee but was capable of being split into its component parts and on this basis the Board allowed some of the expenses to be deducted and not others. The tax representative took this decision as an invitation to claim deduction of all of the service fees in the present case on the basis that they were indivisible fees. Indivisible they may have been but that does not mean that the fees are necessarily deductible.

Apparently it is the practice of the Commissioner in cases such as the present on the authority of D61/91 to look behind the corporate veil of the service company and to allow as deductions those expenses of the service company which are attributable to the business of the Taxpayer. For this reason we have set out in full the reasons given by the Commissioner for his determination. Provided that the service fee is divisible we endorse what the Commissioner has said. The approach taken by the Commissioner is practical but perhaps too lenient. Boards of Review are bound by the provisions of the IRO and have no power to deviate therefrom. A Board of Review can only adopt the approach of the Commissioner if it can find as a fact that the fee is divisible. In the present appeal the representative expressly argued that the fees were indivisible and this had drawn the attention of the Board to the facts. It is, of course open to the Commissioner in an appropriate case to make such a finding of fact without being prompted by the Taxpayer. ‘Caveat emptor’ may well become ‘Caveat taxplanner’ in such circumstances. (In the days of the Roman Empire tax planning was not prevalent and so have to borrow an English word in restating the maxim.)

The Board orders that the assessments against which the Taxpayer has appealed should be remitted back to the Commissioner to assess the profits of the Taxpayer on the basis that the service company and the service agreement are disregarded. This may mean having to restate some of the assets of the service company for the purpose of allowing depreciation allowances. We assume that there is a procedure which is followed in section 61 cases to permit this. If there are any problems we grant to the parties leave to apply to this Board.