Case No. D33/01

Profits tax – deductible expenses – section 61 of the Inland Revenue Ordinance ('IRO') – whether entertainment expenses, office facilities expenses and equipment rental are incurred in the production of chargeable profit – onus of proof.

Panel: Ronny Wong Fook Hum SC (chairman), Shirley Conway and Vincent Lo Wing Sang.

Dates of hearing: 12 January and 3 February 2001.
Date of decision: 21 May 2001.

The taxpayer is a certified public accountant. He commenced his practice in the name of Company L on 7 October 1987. Company L used Company C's equipment as a lessee since commencement of its practice. Company B occupied only about 17% to 38% of the Centre Q Office where Company L occupied 62% to 83%. Company M was the vehicle for sharing the common operating costs pertaining to the Centre Q Office between Company B and Company L.

The taxpayer claimed deductions in respect of entertainment expenses, office facilities expenses and equipment rental. The Commissioner was not satisfied that the equipment rental was incurred by Company L for the production of its assessable profits and was an artificial transaction within the ambit of section 61 of the IRO. The Commissioner further disallowed the claim for deduction of entertainment expenses. In respect of office facilities expenses, the Commissioner deducted the level charged in the year of assessment 1997/98 to the level of the year of assessment 1996/97.

Held:

1. The Board found that the taxpayer was evasive in the course of his evidence and was simply not being candid in relation to the beneficial ownership of Company C, a company which he and members of his family have undoubted control. The Board therefore views the evidence of the taxpayer with serious reservations.

2. The Board has to consider each item of expenses claimed objectively and asks itself the extent, if any, each item is allegedly incurred in the production of chargeable profits (D94/99, IRBRD, vol 14, 603 applied). The Board was not persuaded that the taxpayer had indeed incurred rental equipment to the amount as claimed. It is

therefore inappropriate for the Board to disturb the approach adopted by the Commissioner.

3. The Board found that whilst the taxpayer asserted in his oral evidence that actual payments were made in respect of such charges, he adduced no evidence to substantiate that assertion. The onus rests on the taxpayer to satisfy the Board that the full extent of office facilities expenses claimed by the taxpayer was incurred in the production of his chargeable profits.

4. The Board accepted that the Commissioner did not invoke section 61 of the IRO in her determination. The taxpayer would be deprived of an adequate opportunity to meet a case on section 61 (D41/91, IRBRD, vol 6, 211 followed).

5. Under section 68(4) of the IRO, the onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant. On the basis of the taxpayer' s evidence, the Board was prepared to allow 80% of the claim of the entertainment expenses and had not allowed his claim in full as the Board was not satisfied that expenses incurred in meetings with fellow certified public accountants; in gifts purchased for New Year party and in staff lunch or staff party were incurred in the production of chargeable profits. Furthermore, the taxpayer had not given evidence in relation to the rest of the items in the credit card statements. The Board therefore adopted a broad percentage, which the Board considers fair in the circumstances.

Appeal allowed in part.

Cases referred to:

Lo v Lo 2 HKTC 34
Copeman v William Food & Son Ltd 24 TC 53
Earlspring Properties Ltd v Guests [1993] STC 473
Seramco Trustee v Income Tax Commissioner [1977] AC 287
D96/89, IRBRD, vol 6, 364
D94/99, IRBRD, vol 14, 603

D41/91, IRBRD, vol 6, 211

Ng Yuk Chun for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

Background

1. In about 1977, Mr A commenced practice as a certified public accountant in the name of Company B.

2. Company C is a company incorporated in Hong Kong on 29 November 1985. It commenced business on 9 July 1986 in providing corporate secretarial service.

(a) According to its annual return made up to 29 November 1995, its shareholders were:

- Ms D holding one share;

- Company E holding one share and

- Company F (a Liberian company) holding 7,998 shares.

Before 1992, the company was beneficially owned by the Taxpayer and his wife.

(b) Its directors:

(i) According to its annual return made up to 29 November 1995, its directors were:

- the Taxpayer;

- Ms D (the Taxpayer' s wife) and

- Ms G (the Taxpayer' s sister).

(ii) Ms H (another sister of the Taxpayer) was appointed an additional director on 1 May 1996.

(iii) On 18 December 1996, Ms I (the Taxpayer's daughter) was appointed an additional director.

(iv) According to an employer's return dated 28 April 1997, the Taxpayer was employed by Company C as director for the year ended 31 March 1997. He did not receive any salary but was provided with a quarter at a flat at Housing Estate J ('Property I').

(c) In the years ended 30 April 1991 to 1997, Company C incurred the following sums in acquiring office equipment.

Year ended 30 April	**Amount** $
1991	3,475
1992	14,044
1993	44,475
1994	Nil
1995	13,182
1996	63,950
1997	39,550
	178,676

(d) The profit and loss accounts of Company C for the year ended 30 April 1987 to the year ended 30 April 1997 is summarised in Appendix I annexed to this decision. There is no evidence before us in relation to the years ended 30 April 1994 and 30 April 1995.

(e) On 9 May 1987, it entered into an agreement with Company K for the hire purchase of one unit of Ricoh plain paper copier. Company C made its final payment in about September 1988. Ownership of the Ricoh plain paper copier passed to Company C.

(f) The accounts of Company C contained the following entries:

	Year ended 30-4-1994 $	**Year ended 30-4-1995** $	**Year ended 30-4-1996** $	**Year ended 30-4-1997** $
Equipment rental income				
Company B	78,000	96,000	96,000	64,000
Company L	480,000	480,000	600,000	780,000

	558,000	576,000	696,000	844,000
Director' s fee				
Ms G	129,000	180,000	180,000	180,000

(g) Company C received fees from 215 clients in the year of assessment 1994/95, 225 clients in the year of assessment 1995/96 and 234 clients in the year of assessment 1996/97.

3. Company E is a company incorporated in Hong Kong on 21 November 1986.

(a) According to its annual return made up to 21 November 1995, its shareholders were the Taxpayer holding eight shares and his wife holding two shares.

(b) According to its annual return made up to 21 November 1995, the Taxpayer and his wife were its two directors. On 18 December 1996, Ms I was appointed an additional director.

(c) By an agreement dated 30 November 1992, Company E acquired Property I for $2,330,700.

4. Company M is a company incorporated in Hong Kong on 28 November 1986. It subsequently changed its name to Company N. Its principal activities at the material times were in provision of office facilities services.

(a) According to its annual return made up to 28 November 1995, Company C and the Taxpayer were the registered holders of its two issued shares.

(b) According to an employer' s return dated 23 April 1991, Ms O was employed by Company M as a director for the period between 1 April 1990 and 31 March 1991. Ms O did not receive any income from such employment but she did have the benefit of a flat at Housing Estate P (' Property II') which was provided to her as her quarters for the period. Ms O remained employed as director on the same terms for the years ended 31 March 1992 to 31 March 1997.

(c) According to its annual return made up to 28 November 1995, its directors were:

- the Taxpayer;

- Ms H and

- Ms O.

Ms O resigned her directorship on 10 December 1997.

The Taxpayer resigned his directorship on 8 May 1998. Company C was appointed an additional director on the same day.

(d) A unit at Centre Q (' the Centre Q Office')

(i) By letter dated 3 April 1991 addressed for the attention of the Taxpayer, Company R offered to Company M a tenancy in respect of the Centre Q Office for three years commencing from 1 July 1991 at $54,750 per month with an option to renew for another two years at the open market rent. The Centre Q Office is of an area of about 2,190 square feet.

(ii) By letters dated 10 July 1991, Company M wrote to the Hong Kong Society of Accountants giving its consent for use of the Centre Q Office as the registered office on the practising certificates of the Taxpayer and Mr A.

(iii) By a letter of confirmation dated 6 July 1994, Company M renewed its tenancy in respect of the Centre Q Office for two years with monthly rental of $91,980.

(iv) By a tenancy agreement dated 17 December 1996, Company M was granted a further term in respect of the Centre Q Office for three years from 8 July 1996 with rental at $62,301 per month.

(e) For the year ended 31 March 1995, one Mr S (brother of the Taxpayer) was employed by Company M as its ' Maintenance Officer' with salary totalling $140,000 for the year. For the year ended 31 March 1996, his salary was increased to $205,000. His salary was further increased to $240,000 for the year ended 31 March 1997.

(f) The accounts of Company M contained the following entries:

Item	**Year ended 30-4-1994** $	**Year ended 30-4-1995** $	**Year ended 30-4-1996** $	**Year ended 30-4-1997** $

Office management fee received				
Company B	788,000	792,000	792,000	792,000
Company L	50,000	630,000	396,000	1,098,000
Company C	230,000			
	1,068,000	1,422,000	1,188,000	1,590,000

Salaries				
Mr S	140,000	205,000	230,000	240,000
Director' s quarters expenses				
Ms O	150,000	150,000	150,000	160,000
Rent and rates				
	732,379	1,049,407	1,215,940	972,816

(g) In the six years ended 30 April 1997, Company M incurred the following expenditures in decoration and acquisition of furniture:

Year ended 30 April	**Amount** $
1992	676,177
1993	6,140
1994	Nil
1995	Nil
1996	13,500
1997	Nil
	695,817

5. The Taxpayer is a certified public accountant. He commenced his practice in the name of Company L on 7 October 1987.

(a) The profit and loss accounts of Company L is summarised in Appendix II of this decision.

(b) Ms T worked as corporate secretarial manager of Company L. She resigned from that position on 24 July 1995.

6. By a debit note dated 30 April 1996, Company M debited Company L $396,000 being ' Fee for granting licence to you for using our office at [the Centre Q Office] for the year ended 30 April 1996.'

7. By a debit note also dated 30 April 1996, Company C debited Company L $600,000 being ' Rental charges for our computers, printers, copier, binders etc for the use of your audit teams for the year ended 30 April 1996.'

8. By a debit note dated 30 April 1997, Company M debited Company L $1,128,000 in respect of ' Fee for granting licence to you for using our office at [the Centre Q Office] for the year ended 30 April 1997' .

9. The Taxpayer claimed deductions in respect of:

(a) entertainment expenses of $346,486 for the year of assessment 1996/97

(b) office facilities expenses:

(i) $396,000 for the year of assessment 1996/97.

(ii) $1,098,000 for the year of assessment 1997/98.

(c) equipment rental:

(i) $600,000 for the year of assessment 1996/97.

(ii) $780,000 for the year of assessment 1997/98.

Correspondence between the Revenue and the parties concerned

10. Equipment rental:

(a) By letter dated 18 January 1989, in respect of equipment rental of $120,000 incurred for the period from 1 May 1987 to 16 May 1988, the Taxpayer was asked to provide various particulars including a list of the equipment rented and the reasons that the equipment was used in the production of the assessable profits. In his reply dated 31 January 1989, the Taxpayer informed the Revenue that the rental was paid to Company C ' in respect of the computer system occupied by us for preparing documents for our client.'

(b) The Taxpayer explained in his letter dated 7 February 1998 to the Revenue that ' No written agreements were prepared in these respects. The sum of ... $600,000 covered all necessary equipment together with casual labour provided for running our business. The amounts were fixed by referring to

the sums involved in previous years. Given the benefits gained therefrom for earning our fees, the sums paid should be reasonable.'

(c) By letter dated 21 September 1998, Company C informed the Revenue that its equipment rental income covers ' photocopying machine, typewriters, computers, printers and other office machines. The rental lasted almost twelve years and was fixed by reference to the preceding rental and new machines added with inflationary adjustments. No written agreements were prepared for these years.'

(d) By letter dated 21 December 1998, Company C further informed the Revenue that Company C, Company B and Company L ' were working associates and all three parties could use the equipments [*sic*] on first come first use basis.'

11. Office facilities expenses:

(a) The Taxpayer in his letter dated 7 February 1998 explained that the sum of $396,000 for the year of assessment 1996/97 ' covered office space granted for our professional staff with numbers ranging from ten to fifteen' .

(b) Company M pointed out in their letter dated 21 December 1998 that ' We have allowed Company B, Company L and Company C to place their chattels and allowed their staff members to work in the captioned premises during the captioned periods. We have more than twenty working stations. All three licensed parties can use the premises whenever they need and can use the working stations and storage facilities on a first come first served basis.'

12. Entertainment expenses:

(a) In his letter dated 15 January 1998, the Taxpayer explained to the Revenue the circumstances leading to his claim for $346,487 as ' Entertainment' in the year of assessment 1996/97. The Taxpayer pointed out that ' We have faced critical competition from part-time practitioners of our industry which are offering very low fee scale to bid appointment from our clients and encountered tendency in losing a high number of our jobs during past year. To maintain our engagement with clients, we could not sit and wait for reappointment without joining the social meetings of our clients' directors/management. As a matter of social courtesy, we have to contribute at least once out of several such meetings, the relevant cost by either paying the bills of the meetings in restaurants or donating souvenirs on

festival gatherings. The captioned sum was therefore incurred as such during the year. These actions proved to be successful in increasing the firm' s income for the year as well as the following year and also helping our firm in upkeeping the clientele in future.'

(b) By letter dated 24 January 1998, the Taxpayer was asked by the Revenue to confirm that detailed records and vouchers were kept in respect of these expenses and the Taxpayer was asked to furnish copies of the relevant account taken from the ledger ' showing the date, nature of expense and amount incurred.'

(c) By letter dated 7 February 1998, the Taxpayer confirmed that ' details and payment receipts were kept' . By letter dated 11 March 1998, the Taxpayer furnished to the Revenue a copy of the ledger account.

(d) The ledger accounts are computer printouts bearing the caption ' G/L Account Activity Detail Report' . The printouts contain dates of various transactions under the ' Account Name' of ' OFF. – Gifts & Enter.' The majority of the transactions were described as ' Lunch' , ' Dinner' or ' Gift' followed by a reference code. There are other items such as ' Coffee & Food' and ' Badminton tournament' which make no reference to any client. In his letter dated 25 June 1998, the Taxpayer explained that the code indicates that the sum in question was incurred ' with business associates, for example, professionals or potential clients.'

(e) By letter dated 14 May 1998, the Revenue pointed out that ' It is a well established principle that a gift is not allowable for profits tax purposes ... Furthermore, many of the transactions were "lunches" without any indication who took the lunches and whether they were actually for business purposes.' The Revenue proposed to disallow one half of the amount charged.

(f) The Revenue' s proposal was rejected by the Taxpayer.

(g) By letter dated 22 April 1999, the Taxpayer was asked to furnish reasons for making various gifts, the full name, address and identity card number of the recipients and to provide particulars on the purpose of each lunch/drink/dinner.

(h) By letter dated 4 June 1999, the Taxpayer was also asked to furnish copies of invoices and receipts.

The determination of the Commissioner

13. In relation to equipment rental, the Commissioner pointed out that the total cost of acquisition of office equipment revealed in the accounts of Company C for the seven years ended 30 April 1997 amounted to $178,676. It is thus totally commercially unrealistic for Company L to have paid an annual sum of $600,000 and $780,000 for the years of assessment1996/97 and 1997/98 respectively in order to secure the use of such equipment. It is particularly so when the other co-user, namely Company B paid only $96,000 and $64,000 for use of the same equipment. In the circumstances, the Commissioner was not satisfied that the equipment rental was incurred by Company L for the production of its assessable profits. The Commissioner was of the further view that the arrangement is an artificial transaction within the ambit of section 61 of the IRO.

14. With regard to office facilities charges:

(a) For the year of assessment 1996/97, the total amount of rent paid by Company M to its landlord was $1,215,940 whilst the total amount of office facilities charges received by it from Company L and Company B was $396,000 and $792,000. The Commissioner took the view that the allocation of rental expenses between Company L and Company B for this year is in order and hence no adjustment for the amount of $396,000 charged to Company L' s account is required.

(b) For the year of assessment 1997/98, the total amount of rent charged to Company L' s account increased from $396,000 to $1,032,000. The Taxpayer gave no explanation for such drastic increase. In view of the fact that there was actually a decrease in the amount of rent paid by Company M to its landlord, the Commissioner considered it commercially unrealistic for Company L to have agreed to the drastic increase in the amount of rent paid by it. As the amount of rent paid by Company B for the year of assessment 1997/98 remained the same as that paid for the previous year, the Commissioner endorsed the assessor' s approach in restricting the deduction to the level charged in the year of assessment 1996/97 (that is, $396,000).

15. With regard to the Taxpayer' s claim for deduction of entertainment expenses, the Commissioner disallowed the Taxpayer' s claim in view of his failure to supply the information requested.

The evidence before us

16. The Taxpayer and Ms U gave sworn testimony in support of the Taxpayer' s appeal.

17. According to Ms U:

(a) She joined Company L in October 1994 as an ' audit semi senior' earning about $9,000 per month. Her main duties were in doing auditing work for clients of the firm. She was not involved in the administration of the firm and has no knowledge of the arrangements between Company C, Company M and Company L.

(b) She produced a layout plan of the Centre Q Office and drew our attention to the location of various computers and printers which she used frequently in the course of her audit work.

(c) She further produced a set of debit notes of Company L. She told us that the debit notes have to be printed by a special Panasonic printer which has no modern equivalent.

18. The Taxpayer commenced his evidence by reading page after page the documents in bundles which he submitted to the Board on an intermitted basis. Considerable amount of time was wasted in the process. The following are the salient points from his evidence:

(a) In relation to office facilities charges: The amounts were fixed at the year end dates. The charge for the year ended 30 April 1996 ($396,000) was ' somewhat below the amount that ought to be charged at that time because the management of Company M did not maybe take into account the increase in rent at that time.' The amount was determined in order to share the costs with Company M. Actual payments were made in respect of such charges. He cannot recall the frequency of such payment.

(b) In relation to equipment rental, he pointed out that his firm used the machinery very frequently. He also laid emphasis on the unique printer that could be used as a typewriter as well as a printer. He asserted that Company C had purchased a photocopying machine, a printer, a microwave and a water fountain in further replenishing its equipment. He said that the rental was determined by Ms O as she was responsible for the accounts. He produced for the first time the following justification in support of this item.

	Year ended 30 April 1997 $	**Year ended 30 April 1996** $
Photocopying machine		
Photocopy meter	342,590	414,625

	(68,518 copies at $5 per copy)	(82,925 copies at $5 per copy)
Computers and printers		
Printouts		
- For 200 audit jobs and 250 tax jobs each year	512,500	512,500
- For bookkeeping 1 client x 800 pages per month = 9,600 pages per year x $10	96,000	96,000
Letters 4000 pages per quarter x 4 = 1,200 pages per year x $10	12,000	12,000
Debit note printing 286 debit notes x 10	2,860	2,970
Other equipment e.g. fax, typewriters, shredders etc	10,000	10,000
Charges based on prevailing charging rate to other clients	975,950	1,048,095
Equipment rental charged to Company L	780,000	600,000

This was his own estimate because he has ' no idea how they charge' .

(c) In relation to entertainment expenses:

(i) At the direction of this Board, the Revenue prepared a schedule of the disputed items leaving a column for the Taxpayer to fill in so as to identify the nature of each item of expenditure. The schedule was sent to the Taxpayer on 22 January 2001. The Taxpayer made no effort to fill in that column for the purpose of the adjourned hearing on 3 February 2001. His application to further adjourn the hearing for this purpose was refused by this Board as the issue was repeatedly canvassed in previous correspondence between the Taxpayer and the Revenue and the schedule should have been part of the Taxpayer' s own preparation to discharge his onus.

(ii) In the course of his evidence, the Taxpayer was initially reluctant to disclose the identity of his clients represented by each code. ' This

appears not to be a tax question since the law cannot give me the right to ask for the identity card number. Also, there is legal legislation in Hong Kong that we cannot obtain copies of the identity card from any other person.'

(iii) He was at pains to point out that the expenses spent led to an increase in fees of about $1,200,000 for 1997.

(iv) He then gave the following explanation with reference to entries in credit card statements issued by Bank V.

Date	**Amount** $	**Entry in the statement**	**Explanation by the Taxpayer**
1-1-1996	4,035	Karaoke Box 1	Staff party after work of stock-taking
3-1-1996	190	Restaurant 2	Lunch with Mr W, director of Company 3, client of Company L
3-1-1996	3,030	Restaurant 4	Dinner with Mr X, accounting manager of Company B
4-1-1996	410	Hotel 5	Dining with director of Company 6, an audit client of Company L
7-1-1996	700	Hotel 5	Dinner with director of Company 7
8-1-1996	200	Restaurant 8	Lunch with director of Company 9
8-1-1996	750	Restaurant 10	Dinner with the accountant of Company 11 on the day after completion of audit
10-1-1996	260	Club 12	Lunch meeting with another certified public accountant
10-2-1996	190	Restaurant 13	Staff lunch
10-2-1996	1,302	Club 14	Dinner and meeting with Company 15
12-2-1996	155	Restaurant 16	Lunch with the director of Company 17
14-2-1996	200	Company 18	Gift for New Year

			party – exchange of gifts with own staff
14-2-1996	300	Restaurant 19	Lunch with the accountant of Company 20 after finishing the accounts
14-2-1996	712	Restaurant 21	This is with Company 22
14-2-1996	160	Restaurant 23	Afternoon tea with Mr Y of Company 24 when the Taxpayer went to his office
29-2-1996	780	Restaurant 8	Lunch with Mr X, accounting manager of Company B
29-2-1996	480	Hotel 5	Dinner with accounting staff of Company 25. Some of the subsidiaries of Company 25 had appointed Company L as auditors.
2-3-1996	495	Restaurant 26	Dinner with the accountant of Company 27 after meeting for discussion of the account for the purpose of the audit.
2-3-1996	550	Restaurant 13	Lunch with Company 28 after meeting to discuss the affairs of the accounts of the company
4-3-1996	570	Hotel 29	Dinner with the management of Company 30, audit client of Company L
5-3-1996	700	Restaurant 31	Dinner with Company 32
5-3-1996	450	Restaurant 13	Business meeting with two other certified public accountants.

5-3-1996	490	Restaurant 33	Dinner with Mr X, accounting manager of Company B

He explained that the entertainment expenses for 1996 were higher than those charged for previous years because the market situation was wholly different since 1995. Other than twelve pages of statements in respect of the aforesaid credit card account with Bank V, he is not prepared to produce other information as he does not wish his clients being vexed by investigations from the Revenue.

He said he kept the credit card receipts with the names of the persons entertained written on the back. He did not produce any of those receipts before us.

(d) He said he has no knowledge of the identity of the beneficial owner of the Liberian company, Company F. He could not offer any explanation as to why additional shares in Company C were allotted to Company F in 1992. He refused to answer directly the question whether he is the beneficial owner of Company C.

(e) Ms G is his sister. She was sent by Company C to Country Z with the view of opening an office in that country.

(f) Ms H is also his sister. She was employed by Company L as a senior audit assistant.

(g) Mr S is his brother. He is responsible for upkeeping all the office work for Company M.

(h) Ms I is his daughter.

(i) Ms O is the secretary of Company B.

(j) At first, he conceded that Company M is ' virtually controlled by me and owned by me' . He later said that ' Company M should be 50% owned by Mr A personally.'

Case of the Taxpayer

19. Equipment rental

(a) Company L used Company C's equipment as a lessee since commencement of its practice on 7 October 1987.

(b) In the ordinary course of Company C's business, Company C charged its clients photostatic charges for use of its photocopier. These charges are calculated on similar basis to the equipment rental charges levied on both Company L and Company B.

(c) The equipment rental charges of $600,000 for the year of assessment 1996/97 and 780,000 for the year of assessment 1997/98 have duly been accrued in the accounts of both Company L and Company C.

(d) According to Lord Brightman in Lo v Lo 2 HKTC 34 at page 71, deductions under section 16(1) of the IRO are not confined to sums actually paid by the taxpayer. The words 'expenses ... incurred' in that section include a sum which there is an obligation to pay. In using the computers and photocopying machines of Company C, Company L incurred expenses which Company L was obligated to pay.

(e) The words 'wholly and exclusively' are not part of our profits tax law. Copeman v William Food & Son Ltd 24 TC 53 and Earlspring Properties Ltd v Guests [1993] STC 473 are inapplicable as they are based on legislation incorporating the 'wholly and exclusively' concepts.

(f) Section 61 of the IRO is inapplicable:

(i) The Commissioner is not entitled to invoke section 61 as the assessor did not use that section in arriving at his assessment.

(ii) As pointed out by Lord Diplock in Seramco Trustee v Income Tax Commissioner [1977] AC 287 whether a transaction can properly be described as artificial or fictitious depends upon the terms of the particular transaction that is impugned and the circumstances in which it was made and carried out.

(iii) The original cost of a supplier's machinery should have no bearing to the selling price of the product manufactured from that machinery.

(iv) There was genuine provision of equipment by Company C to Company L and genuine use of such equipment by Company L. From Company C's point of view, it is commercially realistic for

that company to receive $600,000 and $780,000 for use of its machines.

(g) The effect of section 61 is to restore the taxpayer' s position to his pre-tax planning status and ' the person concerned shall be assessable accordingly' .

20. Office facilities

(a) The Commissioner placed no reliance on section 61 of the IRO in reducing the deduction from $1,032,000 to $396,000. No such reliance can be placed for the purpose of the appeal before us.

(b) Out of the maximum capacity of 24 staff working stations, Company L occupied 15 to 20 seats during the two years in question. Company B occupied only about 17% to 38% of the Centre Q Office whereas Company L occupied 62% to 83%. ' There is a contractual obligation to pay Company M for such occupation by Company L.'

(c) Both Company M and Company L property accrued the office facilities charges in their accounts.

(d) Company M was the vehicle for sharing the common operating costs pertaining to the Centre Q Office between Company B and Company L. The office facilities charges were Company M' s only source of income

(e) Company M had undercharged Company L for the year ended 30 April 1996. The position had to be rectified in the year ended 30 April 1997 in order to enable Company M to meet the claims of its landlord. To avoid the landlord seeking re-possession, Company L made the necessary payment totalling $1,032,000 to the year ended 30 April 1997.

21. Entertainment expenses

(a) He did not have sufficient time to complete the schedule prepared by the Revenue at the direction of this Board. He received the schedule on 23 January 2001 shortly before the Chinese New Year holidays and he was notified by this Board on 29 January 2001 of the resumed hearing on 3 February 2001.

(b) The Revenue is not justified in asking for the full names and addresses of the recipients of various gifts with their identity card numbers. The personal

identities and details of recipients are not relevant. ' So long as the recipients were associated with the business of the Taxpayer, tax deductions should be allowed.'

(c) He has given full explanation on the expenses claimed in the course of his evidence.

Case of the Respondent

22. There is no attempt on the part of the Revenue to incorporate the concepts of ' wholly and exclusively' into the realm of profits tax. Section 16 of the IRO permits deductions ' *to the extent to which they are incurred ... in the production of profits*' . The words ' to the extent' constitutes the basis for apportioning expenses that are incurred partly for the production of chargeable profits and partly for other purposes.

23. Whether a sum was expended for the purpose of producing chargeable profits is to be tested objectively. Copeman v William Flood & Sons Ltd and Earlspring Properties Ltd v Guest are cited in support of this proposition.

24. The Board of Review has endorsed this approach in D96/89, IRBRD, vol 6, 364 and D94/99, IRBRD, vol 14, 603. In the latter case, the Board said at page 611:

> ' *Mr B said that it was solely a matter for the Taxpayer and Company D as to what the fair and reasonable service would be. We accept the Revenue's submission that the matter had to be assessed objectively. That is not to say that we are lifting the corporate veil. Nor are we saying that the Taxpayer is not free to decide its own affairs. The Taxpayer is free to give away part of its income as it so wishes to a related company or to a relative or indeed to any third party. The question here is whether that payment is a deductible expense in law when computing the chargeable profits. This question must be answered objectively. The agreement between the Taxpayer and Company D does not preclude us from examining whether the payment is or is not a deductible expense incurred in the production of profits.*'

At page 612, the Board went on to say:

> ' *Such expense must have been bona fide incurred in the production of profits. We must look at all surrounding circumstance. For example, the relation between the payer and the payee is a relevant circumstance. So is the purpose or the reason of the payment. The basis and the breakdown of the amount are also important. The lack of a rational basis may lead us to the conclusion that*

the amount is wholly arbitrary, lacking in commercial reality, and thus not bona fide incurred.'

25. Equipment rental:

(a) On the basis of D41/91, IRBRD, vol 6, 211, the Commissioner is entitled to invoke section 61 in her determination.

(b) The equipment rental of $600,000 and $780,000 for the respective years of assessment 1996/97 and 1997/98 was grossly excessive and was not incurred by the Taxpayer in the production of Company L's assessable profits. The pricing arrangement is commercially unrealistic and is an artificial transaction within the ambit of section 61 of the IRO.

(c) The Taxpayer admitted that the schedule referred in paragraph 18 above was prepared by him shortly before the hearing. That schedule has little evidential value. That schedule was further amended in the written closing submission of the Taxpayer dated 23 February 2001. That schedule relied on readings shown on the meter of the photocopier provided by Company C. This is incorrect as it ignores the fact that the photocopier was also used by Company B and Company C itself. Furthermore, the actual cost in providing the equipment to Company L as shown in Company C's account is not significant.

26. Office facilities:

(a) The office facilities charge of $1,032,000 for the year of assessment 1997/98 was grossly excessive and could not have been incurred by the Taxpayer for the sole purpose of producing Company L's assessable profits. The pricing arrangement is commercially unrealistic and is an artificial transaction within the ambit of section 61 of the IRO.

(b) The amount paid for use of the Centre Q Office for each of the previous four years ranged from $330,000 in the year of assessment 1993/94 to $396,000 in the year of assessment 1996/97. There is no good reason for the sharp increase of the payment to $1,032,000 in the year of assessment 1997/98. This is particularly so when there was an actual decrease of rental paid by Company M to the landlord since 8 July 1996 and when the amount paid by Company B remained the same.

(c) In relation to the justification given by the Taxpayer in his closing written submission, there is no evidence to support the claim that Company L had

underpaid the office facilities charge in previous years and it had a contractual obligation to make good the loss sustained by Company M in the year of assessment 1997/98.

(d) The loss of Company M was the result of charging salary in favour of Mr S and of the provision of quarter to Ms O. The Taxpayer was evasive in relation to their roles in the company.

(e) Even if office facilities were incurred by the Taxpayer, the sum of $1,032,000 could not have been incurred for the sole purpose of producing Company L' s assessable profits. Pursuant to sections 16(1) and 17(1)(b) of the IRO, it is necessary to apportion the expense. According to Inland Revenue Rules 2A(2), the apportionment has to be made on such basis as is most reasonable and appropriate in the circumstances of the case. There is no evidence to challenge the apportionment in the determination of the Commissioner.

27. Entertainment:

(a) The amount of entertainment expenses charged in the year of assessment 1996/97 is exceptionally high. The assessor is fully justified in asking the Taxpayer to furnish details of expenses including copies of vouchers and receipts to substantiate the claim.

(b) The objections of the Revenue are summarised in the schedule prepared by the Revenue before the resumed hearing on 3 February 2001.

(c) The statements of the Taxpayer' s credit card account with Bank V only demonstrate that expenses in the total amount of $145,536.9 have been incurred by the Taxpayer.

(d) The Taxpayer failed to adduce evidence to prove all the entertainment expenses were incurred by him in the production of his firm' s assessable profits. The expenses should be allowed to the extent of $75,000 which is about one half of $145,536.9 proved to have been incurred by the Taxpayer.

Our decision

28. We agree with the submission of the Revenue that the Taxpayer was evasive in the course of his evidence. By way of example, we have no doubt that the Taxpayer is fully aware of the circumstances leading to the taking by Company F of an interest in Company C. He was simply

not being candid in relation to the beneficial ownership of Company C, a company which he and members of his family have undoubted control. We therefore view the evidence of the Taxpayer with serious reservations.

29. We accept the invitation of the Revenue to follow the approach of this Board in D94/99. We have to consider each item of expenses claimed objectively and ask ourselves the extent, if any, each item is allegedly incurred in the production of chargeable profits.

30. Equipment rental:

(a) We have to consider the extent, if any, $600,000 and $780,000 were incurred as equipment rental for years 1996 and 1997.

(b) We reject the schedule which the Taxpayer produced at the hearing before us. No reference was made to such basis of charge in the extensive correspondence between the Revenue and the Taxpayer. The Taxpayer admitted that he himself did not have personal involvement in determining the amount charged. The matter was handled by Ms O. The schedule is also inconsistent with the Taxpayer' s claim in his 7 February 1998 letter to the Revenue that ' The amounts were fixed by referring to the sums involved in previous years' . There is no suggestion in that explanation that the amount was based on the materials consumed in the year in question.

(c) Rejection of the schedule leaves us with no rational basis for the sums of $600,000 and $780,000. The debit note from Company C to Company L dated 30 April 1996 gives no indication on the contractual arrangement between the parties as to justify the amount debited. Had there been a bona fide arm' s length relationship between Company C and Company L, we find it strange that there was no periodical billing from Company C to Company L as to the amount incurred, no regular entry in the books of Company C and Company L as to the material consumed and no breakdown in the debit note of 30 April 1996.

(d) We are therefore not persuaded that the Taxpayer had indeed incurred rental equipment to the extent of $600,000 and $780,000. The Taxpayer has not put forward any alternative basis for computation of this head of expense. It is therefore inappropriate for us to disturb the approach adopted by the Commissioner.

(e) In these circumstances, it is unnecessary for us to express any view on the Revenue' s alternative case on the basis of section 61.

31. Office facilities:

(a) Whilst the Taxpayer asserted in his oral evidence that actual payments were made in respect of such charges, he adduced no evidence to substantiate that assertion.

(b) We accept the Taxpayer's contention that office space in the Centre Q Office was provided by Company M to Company L. What we find difficult is his further contention that Company L had a contractual obligation to pay Company M the sum claimed. The Taxpayer did not describe the nature of such contractual obligation. The precise terms between Company L and Company M as to the basis for charging the office space used is crucial in determining whether the sum now claimed was truly incurred in the production of the chargeable profits of Company L.

(c) In his written closing submission, the Taxpayer put his case on the basis that ' The so-called drastic increase was due to incorrect accounting estimation of rental on 1 May 1995 by [Company M] and undercharged by approximately $554,353' . What is the nature of the contractual obligation undertaken by Company L that obliges that firm to make up Company M's shortfall arising from its incorrect accounting estimation? The Taxpayer gave us no assistance on this.

(d) The onus rests on the Taxpayer to satisfy us that the full extent of $1,032,000 claimed by the Taxpayer was incurred in the production of his chargeable profits. On the basis of his admission referred to in the preceding sub-paragraph, we are not so satisfied. What he has demonstrated is that the usage of the Centre Q Office was in the production of chargeable profit of Company L. What he failed to demonstrate is that the retrospective fixation of the value of such user was related to a commercial agreement that subsisted at the time of the user as opposed to an obvious attempt to reduce the profit so generated.

(e) The Taxpayer did not put forward any alternative case on the basis of the Revenue's submission of apportionment under Rule 2A of the Inland Revenue Rules. We do not see any reason therefore to disturb the approach adopted by the Commissioner in her determination.

(f) We arrive at this conclusion without reference to section 61 of the IRO. We accept the Taxpayer's contention that the Respondent is not entitled to place reliance on that section in relation to this head of claim. The Commissioner did not invoke this section in her determination. The

Taxpayer would be deprived of an adequate opportunity to meet a case on section 61 as envisaged by the decision in D41/91.

32. Entertainment expenses

(a) Under section 68(4) of the IRO, the onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.

(b) We accept the Revenue's contention that the Taxpayer had succeeded only in proving the incurrence of $145,536.9 by reference to his credit card statements. We are therefore not satisfied that the balance of $200,949.1 ($346,486 - $145,536.9) was truly incurred.

(c) In relation to the sum of $145,536.9, we refer to the evidence of the Taxpayer summarised in paragraph 18(c)(iv) above. We regret that the Taxpayer had not been more co-operative with the Revenue and furnished particulars along the lines summarised in that paragraph.

(d) On the basis of the Taxpayer's evidence so summarised, we are prepared to allow 80% of $145,536.9. We have not allowed his claim in full as we are not satisfied that expenses incurred in meetings with fellow certified public accountants; in gifts purchased for New Year party and in staff lunch or staff party were incurred in the production of chargeable profits. Furthermore, the Taxpayer had not given evidence in relation to the rest of the items in the credit card statements. We have therefore adopted a broad percentage which we consider fair in the circumstances.

33. We wish to conclude by expressing our regret in the way whereby this appeal was being handled by the Taxpayer. The documents were submitted to this Board in a haphazard manner. No thought was given to proper organisation of the materials for the purpose of this complicated appeal. Judging from the high quality of the Taxpayer's written closing submission, we have no doubt that this appeal could have been much better presented had the Taxpayer devoted his early attention to it.

Appendix I

Profit and loss account of Company C

Year ended	30-4-1987 $	30-4-1988 $	30-4-1989 $	30-4-1990 $	30-4-1991 $	30-4-1992 $	30-4-1993 $	30-4-1994 $	30-4-1995 $	30-4-1996 $	30-4-1997 $
Secretarial fee received	132,800	313,252	769,411	756,441	857,298	896,456	1,049,775			1,072,832	1,187,649
Equipment rental income	65,000	150,000	170,000	260,000	338,000	534,000	320,000			696,000	844,000
Interest received		176	3,412	2,926	181	19					
	197,800	463,428	942,823	1,019,367	1,195,479	1,430,475	1,369,775			1,768,832	2,031,649
Operating expenses	183,228	500,607	916,009	1,004,190	1,123,512	1,453,403	1,403,712			1,790,612	2,204,859
Operation (loss)/profit for the year	14,572	(37,179)	26,814	15,177	71,967	(22,928)	(33,937)			(21,780)	(173,210)

Appendix II

Profit and loss accounts of Company L

Year ended	30-4-1991 $	30-4-1992 $	30-4-1993 $	30-4-1994 $	30-4-1995 $	30-4-1996 $	30-4-1997 $
Professional fee agreed	1,625,036	2,812,288	3,029,031	3,928,971	4,031,100	4,769,002	5,927,788
Sundry income	40,166						
	1,665,202	2,812,288	3,029,031	3,928,971	4,031,100	4,769,002	5,927,788
Operating expenses	1,220,187	2,203,018	2,140,110	3,152,159	3,413,945	4,752,118	5,821,566
	1,220,187	2,203,018	2,140,110	3,152,159	3,413,945	4,752,118	5,821,566
Operating profit for the year	445,015	609,207	888,921	776,812	617,155	16,884	106,222
Taxation	75,449	165,601	28,789	116,010	175,295	99,704	
Profit for the year	369,566	443,606	860,132	660,802	441,860	(82,820)	106,222