

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D44/98

Profits tax – additional assessment – burden of proof – sections 51C and 68(4) of the Inland Revenue Ordinance.

Panel: Christopher Chan Cheuk (chairman), Anna Chow Suk Han and Anthony So Chun Kung.

Dates of hearing: 28 April and 6 May 1998.

Date of decision: 15 June 1998.

The taxpayer has been carrying on an insurance agency business. The taxpayer appealed against the decision of the Commissioner of Inland Revenue in respect of the additional profits tax raised on the Taxpayer on the ground that the additional assessments were excessive. The only contention was the amount of expenses that the Inland Revenue allowed in the calculation of the taxable income.

Held:

- (1) The one-third rule does not have any empirical justification upon which its accuracy could be tested. It should not be routinely applied to any specific individual case unless the taxpayer is prepared to accept it.
- (2) Section 68(4) of the IRO puts the onus of proving that the assessments were excessive on the taxpayer.

Appeal allowed in part.

Chu Wong Lai Fun for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

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Appeal

1. This is an appeal by Mr A trading as Company B ('the Taxpayer') against the determination of Mr WONG Ho Sang, Commissioner of Inland Revenue dated 16 September 1997 in respect of the additional profits tax raised on the Taxpayer for the years of assessment 1991/92, 1992/93, 1993/94 and 1995/96. The appeal has been lodged on the sole ground that the additional assessments are excessive.

Proceedings

2. The Taxpayer appeared in person and gave evidence on oath. In the course of giving his testimony he complained that his former tax representative had not properly handled his tax affairs and he also complained about the way he had been treated in the course of investigation. We must say that these subjects are beyond the jurisdiction of the Board and there are proper channels for the Taxpayer to lodge his complaints. We intend not to comment more than this.

Issue

3. The actual incomes for the different years are not in dispute and the only contention is the amount of expenses that the Revenue allows in calculation of the taxable income. The Commissioner having considered the submission of the Taxpayer determined that certain allowances were allowed in full and for the rest he applied what we generally referred to as the one-third rule. In other words he allowed one-third of the assessable profits as the amount spent for the rest of the items without ascertaining the actual amount spent. The one-third rule as claimed by Mrs CHU for the Revenue is the product of a rough generalisation from a number of cases assessed by the Commissioner. Our view is that this one-third rule does not have any empirical justification upon which we can test its accuracy. Neither do we think that it should be routinely applied to any specific individual case unless the taxpayer is prepared to accept it. In the present case the Taxpayer rightly objects to its application. We therefore reserve our position on this matter and have to examine the evidence as presented to us.

Evidence

4. The Appeal Bundle forms the essential part of the documentary evidence. In the course of giving evidence the Taxpayer produced three agent's production reports prepared by Company C, an insurance company as at November 1994, November 1995 and November 1996 respectively and accordingly marked as Exhibits 'A1', 'A2' and 'A3'. To assist the Board the Revenue produced a summary of the returns filed by the Taxpayer for the relevant years of assessments, marked as Exhibit 'R1', which we find very comprehensive and useful.

5. The Taxpayer gave evidence which can be briefly summarised as follows:

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- (a) The Taxpayer has been carrying on an insurance agency business in the name of Company B since 1983.
- (b) He was at the material times employed by Company C as a unit manager with a team of 3 to 10 agents working under him.
- (c) Company C provided the office space and the basic furniture whilst the rest had to be provided by the unit manager or the agent himself. He had the exclusive use of a room. The Board did ask for the production of the agreement he had with Company C but the Taxpayer's reply was that he did not have it with him.
- (d) The Taxpayer's income mainly came from commission and agency fees derived from the following three sources:

- (i) Direct Clients

For every client he introduced he was entitled to a substantial first year commission and also a much lesser amount for each of the five subsequent years of renewal. He was also entitled to a year end bonus calculated with reference to the first year commission.

- (ii) General Insurance

The commission came from this source was not significant because he had to give substantial amount of rebate to his clients who had taken life insurance policy with Company C and the arrangement of the general insurance was treated as a complimentary service.

- (iii) Overriding Agency Fees

Company C gave to the unit manager an overriding agency fee to every client introduced by the agent who worked under him.

- (e) The Taxpayer had a very large client basis and he claimed that it was around the region of 2,000. It is difficult for us to assess whether what he claimed is correct as we have seen no concrete evidence to substantiate it.
- (f) However we accept that the nature of his business requires him to keep in constant contact with client but not necessarily in regular or close contact as he wanted us to believe. Occasionally there would be one or two clients who needed his personal service, for example, hospital arrangement etc. We consider this is rare rather than usual.
- (g) He admits that he could not afford to have lavish dinners with his clients or send them expensive gifts. We accept as fact that he did send some free gifts

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like calendars, paper weights and greeting cards. We also accept as fact that occasionally he had dinners, lunches, breakfasts and afternoon teas with clients.

6. The Taxpayer tried to impress us with the three Exhibits 'A1', 'A2' and 'A3' that his income was mainly derived from his personal contact with clients which we are prepared to accept. The key point is how many and to what extent. The three exhibits do not seem to help us very far on these issues. They show that in 1994 the Taxpayer was successful in securing sixty-four new policies, in 1995 forty-three and in 1996 seventy-six. These figures do not give us too much clue to the size of his client basis.

Expenses

7. Based on the evidence before us and facts implied therefrom we make our assessments whether the following expenses should be allowed as claimed by the Taxpayer in his returns.

Secretary Salaries and Allowances

8. We have no hesitation to accept that a person in the Taxpayer's position required the assistance of a secretary or personal assistance to help him to do the routine works like filling in the forms, keeping simple accounts and records and sending greeting cards. We do not agree with the Commissioner's conclusion that the expenses were not incurred in the production of the firm's chargeable profits. The work that had been done by Ms D and her predecessors as described by the Taxpayer in his evidence was directly related to the nature of business of the Taxpayer as an insurance agent. Neither do we have any reason to doubt the contents of the letter written by Ms D and addressed to the Commissioner on 24 July 1997 as shown on page 56 of the Appeal Bundle. We allow this item in full for all the assessment years.

Sub-Agent Commission Paid

9. This item only appeared in the year of assessment 1991/92 and we could not find it in the subsequent years. The reason the Taxpayer gave was that he ceased the practice of using sub-agents. Formerly he paid commission and rebates to any person who introduced clients to him; this caused him a lot of trouble. The amount of additional work and the number of disputes generated from this practice did not justify the income. He decided to abandon the practice of sub-agency since the year of assessment 1992/93. We find truth in what he said and although he produced no evidence to that effect we are prepared to allow this item in full.

Discount and Rebates

10. This item as described by the Taxpayer was mainly related to the general insurance which we have given brief description in paragraph 5(d)(ii) above. We accept that it is a kind of complimentary service provided to his clients. But, in no event are we

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prepared to accept that the rebates or discounts would exceed the amount that he received as in the case of the year of assessment 1993/94 where the total amount he received was \$21,212 whilst the rebate and discounts amounted to \$43,246. This demonstrates that the figures shown under this heading are not reliable and should not be believed.

Entertainment

11. The Taxpayer described to us that the sort of entertainment he gave to his clients was very simple and not expensive. We cannot accept the figures as set out in the Taxpayer's returns because the amount he spent on the sort of entertainment like simple breakfasts, lunches, afternoon teas and dinners could reach an aggregate sum of nearly \$10,000 or more in each month. The greatest hurdle we have in making the assessment is that we have no evidence to show how large his clientele was and how often he entertained his clients. We do not have any documentary or other independent evidence for us to rely on.

Motor Car Running Expenses, Hire Charges and Depreciation

12. The Taxpayer did not give any concrete evidence as to the extent that the motor car had been used for his business. He gave us an example that he carried a client to hospital. He admitted that this did not usually happen. He also explained that he now relied on referrals and had to meet the clients. He needed the car for travelling. But he did admit that he used the car for travelling from home to office and vice versa and also for other private purpose. He did not give us a percentage. Neither do we have any documentary evidence to show the amounts he spent on this item. We firmly believe that there are some documents which he could have readily produced if he wanted to, for example the insurance premium receipts but he chose not to do so. Therefore, we have no basis to make any proper assessment.

Staff Welfare

13. This item only appeared in the year of assessment 1991/92. In the examination-in-chief the Taxpayer hardly remembered what this item was. He mentioned that it could be the part-time worker's salary. If it were so the name of this item was hardly appropriate. We had great suspicion whether such item had ever been spent.

Promotional Expenses and Advertising

14. These two items as described in the Taxpayer's evidence were related to recruitment of new agents. He had to arrange for advertisements in newspapers and also meeting places if not held in the office provided by Company C. He gave no further particulars other than this. Neither could he remember how many times he held such meetings. Given the number of agents working under him as evidenced in Exhibits 'A1' to 'A3' and the number of new recruits we doubted very much he spent as much as he claimed.

Training & Convention Expenses and Overseas Seminar Expenses

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15. We do not know the real nature of the conventions and seminars that the Taxpayer claimed that he had attended. Neither did he produce any receipt to substantiate the claim on these two items.

Telephone, Pager, Printing & Stationery, Postage's and Sundry Expenses

16. We believe that these items just like any other items can easily be substantiated if the proper receipts are produced.

Lack of Documentary Evidence

17. The Taxpayer's explanation for his failure to produce any documentary evidence was that the Revenue did not commence its investigation until several years later. Mrs Chu's main argument is that according to section 51C of the Inland Revenue Ordinance every person carrying on a business in Hong Kong has the obligation to keep sufficient records of his income and expenditure for a period of not less than 7 years. However, given the high rent in Hong Kong we have certain sympathy on those taxpayers if the investigation do not commence until the seven years' period almost expires. In the present case we would have considered very favourably for the Taxpayer had the investigation not included the additional assessment for the year of assessment 1995/96. We have no information when the actual investigation commenced. The earliest correspondence included in the Appeal Bundle is a long letter dated 2 April 1997 from the assessor to the Taxpayer. Even if the investigation commenced on that date (but according to the tenor of the letter it started much earlier), it was only about one year after the return for the year of assessment 1995/96 and there was no reason for him not to keep the documents for that year and produce them to us for consideration.

18. After hearing the testimony and seeing the Taxpayer's demeanour we find as fact that the Taxpayer was a very meticulous and articulate person. He knew full well what he was doing. At the resumed hearing he brought along his friend to help him, for which he gave the excuse that he was not feeling well on that day. Some evidence he could produce was dated as far back as 1991, for example, the donation receipts to an organisation. In other words he could locate the documents if he wanted to produce but for others we do not want to draw any conclusion whether he was unable or he made no effort to trace or locate the various documents.

Decisions

19. Section 68(4) puts the onus of proving that the assessments were excessive on the Taxpayer. We find that the Taxpayer has failed to discharge the burden of proof in most of the items.

20. Accordingly we allow the appeal to the extent that the following items should be deducted in full in respect of the years of assessment 1991/92, 1992/93, 1993/94 and 1995/96 unless otherwise expressly stated:

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- (a) Secretary's salaries & allowances
- (b) Sub-agent commission paid for year of assessment 1991/92

and (c) Accountancy fee.

21. Apart from the above the Board upholds the Commissioner's determination of 16 September 1997 and directs that the additional assessable profits for the relevant years of assessment 1991/92, 1992/93, 1993/94 and 1995/96 be revised in accordance with the Commissioner's determination as varied by the Board's decision herein.

22. The Board further orders that either party will be at liberty to apply in case of dispute or failure to reach agreement as to the amounts of assessments contemplated by this decision.