Case No. D51/05

Profits tax – whether rental expenses incurred in the production of profits – whether transaction 'artificial' or 'fictitious' under section 61 of the Inland Revenue Ordinance ('IRO') – whether sole or dominant motive to obtain tax benefit – whether there should be an apportionment of expenses.

Panel: Benjamin Yu SC (chairman), Ho Kai Cheong and Simon Lai Sau Cheong.

Dates of hearing: 17 December 2004, 27, 28, 29 April and 3 June 2005.
Date of decision: 17 October 2005.

The taxpayers were two doctors, which were then married, who commenced a medical practice in September 1995 ('the Practice'). In July 1997, the Practice relocated to a property which was owned by Company F.

The doctors were the sole directors and shareholders in Company F until late 2003. A tenancy agreement was reached between the Practice and Company F which stated that the monthly rental for the property would be HK$80,000 from May 1997 and May 1998. Subsequently, by letter dated 30 May 1998, Company F informed the Practice that the monthly rental would be adjusted to HK$100,000 for the first year, HK$110,000 for the second year, and HK$120,000 for the next three years. At issue in this appeal was whether the rental could be deducted from the assessable income of the Practice.

The taxpayers submitted that the rent was paid in accordance with their agreement with Company F and constituted expenses incurred in the production of profits of the Practice.

On the other hand, the Inland Revenue Department ('IRD') contended that the rent far exceeded the open market value of the premises, and that the transaction was either fictitious or artificial under section 61 of the IRO, or were entered into for the sole or dominant motive of obtaining a tax benefit. As an alternative, the IRD submitted that insofar that there any element of the rent which was not incurred in the production of profits, that there should be an apportionment of expenses.

The issue before the Board was whether the rental expenses incurred by the Practice during the years of assessment 1997/98 to 2001/02 were deductible from assessable income.

Held:

1. Insofar as the rent for 1997/98 is concerned, the Board's task was not to establish retrospectively what would be the most reasonable rent that can be agreed between landlord and tenant. The proper issue was whether the rent fell outside the range of acceptable market rental such as to raise an inference against the Practice, either that the transaction was 'artificial' or that it was entered into with the sole or dominant motive to obtain a tax benefit.

2. On the facts, the Board held that while the rent paid to Company F for 1997/98 was on the high side, it was not so high as to raise the necessary adverse inference against the Practice.

3. As for the period between June 1998 and March 2002, the rental agreed with Company F was far above market rent. Had it been a bona fide commercial transaction, there was no conceivable basis to agree to a 20% increase in rent in 1998, when there was a general downturn in rental values.

4. Accordingly, the expenditure was not wholly incurred for the production of assessable profits. However, this did not mean that the entire transaction was 'artificial' or 'fictitious' within the meaning of section 61. To the extent that the rent paid to Company F was above market value, the Board held that apportionment was appropriate and permitted in law.

Appeal allowed in part.

Cases referred to:

Seramco Superannuation Fund Trustees v Income Tax Commissioners [1977] AC 287
Cheung Wah Keung v CIR (2002) 5 HKTC 698
D77/99, IRBRD, vol 14, 528
D96/89, IRBRD, vol 6, 364

Taxpayer in person.
Cheng Hau Kwong for the Commissioner of Inland Revenue.

Decision:

The Background

1. Dr A and Dr B commenced a medical practice in the name of Dr A & Dr B ('the Practice') in September 1995. At that time, they were married. They were divorced in 2003.

2. According to the profits tax returns for the relevant years, Dr A and Dr B shared their profits as follows:

Year of assessment	**Profit/loss sharing ratio**	
	Dr A	**Dr B**
1995/96	50%	50%
1996/97	15%	85%
1997/98-2001/02	100%	0%

3. At the hearing of the appeal, the only issue in contention relates to the claim of rental expenses by the Practice during the years of assessment 1997/98-2001/02. Although nominally, the appellants are Dr A and Dr B, it was in fact Dr A who has the conduct of the appeal. He also gave evidence before the Board.

4. From about September 1995 until about June 1997, the Practice had a lease from the Properties Group C at Address D. Starting, however, from July 1997, the Practice moved to premises at Address E ('the Property'), of which the landlord was a company called Company F.

5. Company F is a company incorporated in Hong Kong. At all material times, the company only issued two shares. One share was held by Dr B. The other share was held by Dr A, until he transferred that share to Ms G in November 2003. Dr B and Dr A were also the directors of the company. Dr A resigned from directorship in October 2003. Company F acquired the Property some time in May 1997.

6. We have been shown the following:

(1) A standard form tenancy agreement in Chinese dated 26 May 1997 between Company F as landlord and the Practice as tenant in respect of the Property for a term of one year from 26 May 1997 to 25 May 1998 at the rent of $80,000 per month. The agreement was signed by Dr B on behalf of Company F and by Dr A on behalf of the Practice. That agreement was duly stamped. The chop of the Stamp Duty Office shows the date 25 June 1997.

(2) A standard form tenancy agreement in Chinese dated 18th June 1998 between Company F as landlord and the Practice as tenant in respect of the Property for a term of one year from 26 May 1998 to 25 May 1999 at the rent of $100,000 per month. Certain words were written at the end of clause 1 of the form to the effect that both parties agreed on a fixed term of one year. The

agreement was signed by Dr B on behalf of Company F and by Dr A on behalf of the Practice. This agreement was also stamped. The chop of the Stamp Duty Office shows the date 19 June 1998.

(3) A letter in English dated 30 May 1998 from Company F to the Practice ('the 30 May letter') in the following terms:

'We would like to inform you that the monthly rent of the property situated at [Address E] will be adjusted to

a) HK$100000 for the 1st year

b) HK$110000 for the 2nd year

c) HK$120000 for the next 3 years. (5 years fixed term) from June 1998.

Please kindly sign and return a copy to us if you agree with the above arrangement. Otherwise please give two months' notice in writing if you do not accept the above terms.'

The document bears a signature of Dr A above the caption 'Read and Signed by [Dr A]'

Mr Cheng told us, and Dr A accepted, that this document was not produced to the Revenue until 30 May 2003.

The Parties' contentions

7. It is Dr A's case that during the relevant years of assessment, the Practice paid rent to Company F in accordance with the terms set out in the tenancy agreement dated 26 May 1997 and in the 30 May letter. It is his case that the rent was expenses incurred in the production of the profits of the Practice. Dr A's case is that although he and Dr B were only divorced in 2003, they were separated since 1998. His case is that in all matters concerning the purchase of the Property, the fixing of rental and term of the tenancy, Dr B had the say. In his 'statement of the grounds of appeal', he stated that

'I and [Dr B] had a lot of arguments on raising the children and managing our finances. In 1998, she and the children left for [Country H]. She had informed Social Security of [Country H] about our separation after she arrived at [Country H]. At that time, we agreed verbally that I would own my clinic wholly and she would own [Company F] wholly. In March 2003, we were officially divorced. In

> October 2003, I resigned as a director and shareholder of [Company F] and she resigned as a partner of my clinic according to what had been agreed in 1998.'

Dr A argues that he had no intention to obtain tax benefits and did not in fact obtain any tax benefit.

8. The Revenue, however, contends that the rental paid by the Practice to Company F over the years far exceeded the open market rent of clinic in District I. The Revenue relies on the opinion of the Rating and Valuation Department and contends that the transactions entered into between the Practice and Company F were either fictitious or artificial such that the assessor is entitled to regard them under section 61 of the Inland Revenue Ordinance or were entered into with the sole or dominant motive of enabling the Practice to obtain a tax benefit and the Revenue is entitled to assess the liability to tax of the Practice as if the transaction had not been entered into or carried out or in such other manner as to counteract the tax benefit which would otherwise be obtained. Mr Cheng referred the Board to Seramco Superannuation Fund Trustees v Income Tax Commissioners [1977] AC 287 at 298, Cheung Wah Keung v CIR (2002) 5 HKTC 698 and D77/99, IRBRD, vol 14, 528. There is a third string to the Revenue's bow. Section 16(1) of the Ordinance provides for the deduction of expenses to the extent to which they are incurred in the production of chargeable profits. Section 17(1)(a) and (b) prohibits the deduction of domestic or private expenses, and of expenses not being money expended for the purpose of producing such profits. It is argued that insofar as there is any element in the rental payment which was not incurred in the production of the profits, there should be an apportionment of expenses. Reference was made to D96/89, IRBRD, vol 6, 364 where this was done.

Evidence and analysis

9. We have before us the documents relied on by the parties. We have heard the oral evidence of Dr A. Each side also called a valuer to testify as to their respective opinion of the open market rent of the District I clinic.

10. Dr A told the Board that his clinic in Address D was only 360 square feet, whilst the Property was 725 square feet. He assumed that it would therefore be 100% more expensive. (The amount of rental paid for the Address D clinic was $403,534 for 12 months or $33,628 per month). With inflation, he reckoned the rent would be $80,000. He said he wanted to move (a) because of larger space and he could have two rooms which enabled him to perform more physical examinations, insurance check-up and (b) the Address E was open 24 hours with access to the MTR station. Dr A's evidence was that he could not remember how Company F came to let the clinic to the Practice. He said:

> ' She just told me. Say your wife, "you do this, you do that'. She told me. "I have done something". So, how many years now? It is eight years. I cannot remember things seven or eight years ago. I cannot even remember the exact date.'

11. Dr A said he did ask real estate agent at the time and got the information that the clinic in Address E should rent around $80,000 per month. He reminded the Board that 1997 was the peak and there was shortage of suitable place. The need to have water supply made it even more difficult to locate suitable premises.

12. He explained that after he moved to Address E, he did not want to move, as he had signed a contract with a subsidiary of Company J called Company K. His contract with Company K specifically provided that he would need to have the consent of Company K if he were to relocate his clinic. His evidence is that Company K brought in about $1,800,000 gross income to his clinic. He also told the Board that he had some difficulties with the management of Company K and would not want to risk losing the business by asking for consent to relocate. He said he was separated from Dr B since 1998.

13. The Revenue called Mr Cheng Chun-chung from the Rating and Valuation Department. Mr Cheng Chun-chung was instructed to render his opinion on the open market rental at various dates between 1 June 1997 and 1 April 2002. His opinion as to the open market rental of the Property can be summarised as follows:

1 June 1997	$40,500
1 June 1998	$37,000
1 June 1999	$33,000
1 June 2000	$33,000
1 April 2001	$33,000
1 April 2002	$31,500

14. Dr A called Mr L of Surveyors Company M. Mr L was only asked to render his opinion of the open market rental of the Property as at one date, viz 1 June 1997. His valuation was $70,000 per month.

15. Two points are immediately apparent. First, Dr A did not instruct his expert to give an opinion on any date subsequent to 1 June 1997. Second, there is a big difference in the opinion of the two experts on the open market rental of the Property as at 1 June 1997.

16. The methodology of Mr Cheng Chun-chung and that of Mr L was the same. Both looked at comparables and after taking into account their respective opinion on the necessary adjustments for differences, arrived at an opinion. Whilst there are differences in their respective opinion on adjustment, this does not account for the substantial difference between the two experts. The real reason why their valuations are so substantially different is that certain transactions which Mr L took into account as comparables were regarded by Mr Cheng to be inappropriate for the purpose. Those transactions revealed a much higher unit rate than the other known transactions used by both experts as comparables. Mr Cheng was not prepared to accept these additional transactions as appropriate for a number of reasons: (a) because there are already sufficient number

of good comparables, (b) because these additional transactions are very different from the subject property in terms of location, one is a corner shop very near a pedestrian footbridge and the other two were shops on a different floor level, and (c) because he regarded these additional transactions, in particular, the two on the lower floors as out of line.

17. If the proper question in this case is one of arriving at the open market rental of the District I clinic, there is some force in Mr Cheng's argument that one can exclude certain comparables because of the difference in location. However, the question here is not one of establishing retrospectively what would be the most reasonable rent that can be agreed between the landlord and tenant. Rather, we have to ascertain whether the rent which was agreed falls outside the range of acceptable market rental such as to raise an inference against Dr A, either that the transaction was artificial or that it was entered into with the sole or dominant motive of obtaining a tax benefit, or that the amount of rental paid was not wholly for the purpose of generating the profits.

18. On the evidence, we are left in no doubt that the rent for the period 1997/98 was on the high side. We do not, however, think that it is so high as to raise a clear inference of the kind referred to. We bear in mind the fact that Company F acquired the Property about the same time (in May 1997) as the 1997 tenancy agreement. At that time, the couple had not yet separated. They must have discussed the acquisition of the clinic. They must also have discussed the rent and Dr A must have been prepared to accept it. It is probable that when Dr A agreed the rent of $80,000, he knew it was on the high side, but was prepared not to bother too much since he was a director and 50% shareholder of Company F with his wife. We accept, however, that in 1997 it was the landlord's market and Dr A would probably have to pay a premium to secure a tenancy within a popular estate appropriate to his needs.

19. We are satisfied, although only marginally so, that the taxpayers have discharged the burden of proving that the additional assessment for that year was incorrect. We would accordingly allow the appeal in respect of the year of assessment 1997/98.

20. As for the period from June 1998 to March 2002, Dr A had called no valuation evidence. Mr L agreed that in 1998 rent was generally adjusted downwards. The only evidence on open market rent before this Board is that of Mr Cheng. Quite plainly, the rental which Dr A agreed on behalf of the Practice with Company F was way above the market rent. (The rent expense claimed was $100,000 when the open market rent was $37,000). There is no doubt that because of the Asian Financial Crisis in October 1997, property prices and rental suffered a downturn towards the end of the year and from the beginning of 1998. Had it been a bona fide commercial transaction, we can see no conceivable basis for Dr A to agree to a relatively substantial increase (20%) in the year 1998. When asked about this, he claimed that he was not versed in financial matters. We are unable to accept this. He must have been aware at the time (as he repeatedly told the Board) that 1997 was the peak. We do not overlook Dr A's evidence before us that he did not want to move because of his association with Company K, but even on his

evidence, the problems he had with the management of Company K only surfaced after 1998. We can appreciate why a tenant would have the inertia against moving, but, in the circumstances of the financial situation in 1998, it was extraordinary for the tenant to agree to a 20% increase in rent, especially when the original rent was known to be on the high side.

21. We have noted that the 30 May letter was wholly inconsistent with 1998 tenancy agreement. The latter specifically provided for a fixed term of one year, whereas the former purports to provide for a term of five years. No satisfactory explanation was provided by Dr A for the discrepancy. We have serious doubts over the authenticity of the 30 May letter. In our view, it would be proper to proceed on the basis that the 1998 tenancy agreement governed the legal relationship between the parties. After the one year term expired, Dr A continued to pay and agreed to pay rent which, on the evidence, was far in excess of the open market rental. We find that Dr A was aware that this was so and that for those years of assessment, the expenditure claimed in respect of rental was not wholly expended for the production of the assessable profits.

22. We have, however, some difficulty in accepting the Revenue's argument that the transaction was fictitious or artificial within the meaning of section 61. There is no doubt that Company F did let the Property to the Practice and that the Practice did enjoy the use of those premises. It is our finding that the rent agreed and paid for the period from June 1998 until 2002 was not only substantially above market, but known to be so. We also reject the taxpayers' case that there was any proper commercial reason for agreeing such a rental. This is, however, insufficient to brand the whole transaction as fictitious or artificial. Nor can we come to the conclusion that the sole or dominant motive of the transaction was the obtaining of a tax benefit. That may well be one of the purposes of the transaction, but the main purpose of the transaction was still the letting of the clinic.

23. Nevertheless, we have no doubt that the amount claimed by the Practice as rental for the years of assessment 1998/99 to 2000/01 was not wholly expended for the purpose of the production of the profits. We accept Mr Cheng's argument that apportionment is appropriate here and that apportionment is permitted in law. It is permitted because section 16(1) uses the words 'to the extent'. Rule 2A(2) of the Inland Revenue Rules provides:

> '*Where, apart from or in addition to the circumstances referred to in paragraph (1) as giving rise to an apportionment, it is necessary to make an apportionment of any outgoing or expense by reason of it having been incurred not wholly and exclusively in the production of profits in respect of which a person is chargeable to tax under Part IV of the Ordinance, such apportionment or further apportionment, as the case may be, shall, subject to the provisions of rules 2B and 2C, be made on such basis as is most reasonable and appropriate in the circumstances of the case.*'

24. In the circumstances, Dr A has failed to discharge the burden on him in showing that the assessment for the years 1998/99-2001/02 were incorrect. For those years, Mr Cheng for the Revenue has accepted the need to make an adjustment consequential on a slight modification in the opinion of open market rental.

25. For the reasons we have endeavoured to state, we would allow the appeal to the extent set out in this decision and remit the case to the Commissioner for revision of the assessment in accordance with the opinion of the Board.