Case No. D57/05

Salaries tax – deductions under salaries tax - section 12(1)(a) of the Inland Revenue Ordinance ('IRO') – whether or not whenever the taxpayer carried out the instructions of his clients he incurred a contingent liability under the indemnity in respect of potential non-payment by the clients – whether or not the Bad Debts were necessarily incurred in the production of the taxpayer's assessable income – whether or not the liability to indemnify Company K crystallised upon entering into the agreements and was 'incurred' for purpose of section 12(1)(a).

Panel: Anthony Chan Kin Keung SC (chairman), Melville Thomas Charles Boase and Kenneth Graeme Morrison.

Date of hearing: 5 October 2005.
Date of decision: 10 November 2005.

The taxpayer was employed by Company K, which was a securities company. The main part of the taxpayer's duties was to carry out dealing instructions from the clients. On the same day that the taxpayer signed the Letter of Employment, he had to sign an Indemnity in favour of Company K.

By virtue of the Indemnity, the taxpayer had to indemnify Company K against all non-payments of the clients who were handled or referred by him and against any loss or damage resulted from his negligence in carrying out his duties. Further, under both the Indemnity and the Letter of Employment, any loss or damage suffered by Company K as a result of errors committed by the taxpayer in the dealing activities was to be borne by the taxpayer.

There are two issues before this Board. Firstly, whether the payments made by the taxpayer to Company K pursuant to the Indemnity to settle the debts of his defaulting clients are deductible under section 12(1)(a) of the IRO. Secondly, the quantum of deduction to be made, if the said payments can be deducted, for the assessment years in question.

Held:

1. The provisions of section 12(1)(a) are notoriously rigid, narrow and restricted in their operation. Further, deductions under salaries tax are considerably more restrictive than those under profits tax. However, the Legislature has seen fit to impose different statutory regimes for profits tax and salaries tax and the function of this Board is to

resolve these matters according to the law.

2. The law must be applied with common sense and a proper appraisal of the facts. This Board takes the view that, on each occasion when the taxpayer carried out the instructions of his clients he incurred a contingent liability under the Indemnity in respect of potential non-payment by the clients. To his misfortune, some of these contingent liabilities materialised. This Board also rejects the argument that the Bad Debts were incurred for the production of assessable income rather than in the production of assessment income.

3. This Board takes the view that the terms of the Employment constitute a relevant consideration for purpose of deciding whether the Bad Debts were necessarily incurred in the production of taxpayer's assessable income. Without incurring the risk the taxpayer would not have been able to gain his share of the commission. It seems to be illogical for IR to contend that the taxpayer should be liable for tax on his high level of commission but at the same time refused any deduction when the risk had materialised. This Board is satisfied that the Bad Debts were necessarily incurred in the production of the taxpayer's assessable income (Taylor v Provan [1975] AC 194 and Brown v Bullock 40 TC 1 considered).

4. This Board accepts the taxpayer's submission that the liability to indemnify Company K crystallised upon entering into the agreements with the clients who failed to settle their outstanding accounts with Company K and was 'incurred' for purpose of section 12(1)(a).

Appeal allowed.

Cases referred to:

Mallalien v Drummond [1983] STC 665
Humbles v Brooks 40 TC 500
D36/90, IRBRD, vol 5, 295
Rickets v Colquhoun [1926] AC 1
CIR v Burns 1 HKTC 1181
D7/04, IRBRD, vol 19, 93
D35/04, IRBRD, vol 19, 295
Taylor v Provan [1975] AC 194
Brown v Bullock 40 TC 1

Derek Chan Counsel instructed by Messrs Anthony Kam & Company, Certified Public Accountants, for the taxpayer.

Chow Cheong Po and Wong Ki Fong for the Commissioner of Inland Revenue.

Decision:

1. This is the Taxpayer's appeal against a determination by the Deputy Commissioner of Inland Revenue dated 26 July 2005 ('the Determination') in respect of salaries tax assessments raised on him for the years of assessment 2000/01 and 2001/02.

2. The parties have helpfully informed this Board that there is no factual dispute in this case. We believe that the material facts have been accurately set out in Section 1 of the Determination [pages 6-12 of Bundle B1 ('B1/6-12')].

Facts

3. In a nutshell, the Taxpayer was employed by Company K, which was a securities company, as a 'Dealer's Representative' on or about 2 January 2000 ('the Employment'). The main part of the Taxpayer's duties was to carry out dealing instructions from the clients. His Letter of Employment ('the Letter of Employment') contained the following terms:

> '**DUTIES**
>
> During your employment with (the Company), you shall devote the whole of your time and attention during normal business hours to the business of the Company faithfully and diligently as the Board of Directors of the Company … may direct subject to such restrictions as the Board may from time to time impose, and in particular your duties shall include:
>
> - to observe at all times the rules and regulations of the Company's dealers' manual in full. Any costs incurred as a result of your failure to comply with the Company's rules and regulations will be borne by you;
>
> :
>
> - to carry out dealing instructions from clients carefully and accurately. Costs incurred as a result of your error in dealing, mishandling, overtrade or similar acts will be borne by you;
>
> :

- all general terms and conditions of service as may be laid down by the Company for compliance by all members of its staff in the Staff Handbook or otherwise and such other rules and regulations as may be introduced by the Company from time to time thereafter.

COMMISSION

50% of commission earned by you net of rebates during your employment from securities brokering is to be paid to you within ten days following each month end.

:

SET OFF ARRANGEMENT

You also agree to allow the Company to use part or whole of your commission earned with the Company to repay any commission or bonus draw shortfall you may owe to [Company K].'.

4. On the same day that the Taxpayer signed the Letter of Employment, he had to sign an Indemnity in favour of Company K ('the Indemnity') and the material part of which is as follows:

'IN CONSIDERATION OF (the Company) agreeing to engage me as Dealing Director, I [the Taxpayer], hereby irrevocably undertake and agree to indemnify and keep you indemnified against all non-payments (including without limitation all settlement payments, interests, brokerages fees, commission, stamp duties, levies and all other payments due to you from clients handled or referred by me) and all losses, damages, suits, claims, demands, liabilities, fees, charges, costs and expenses (including all legal costs) of whatever nature which you might suffer or incur on account of or as a result (whether directly or indirectly and including all consequential losses) of any future contracts transactions handled or referred by me or as a result of any acts, negligence, defaults or omissions on my part in carrying out my duties under the aforesaid engagement.

I further undertake and agree to pay to you upon demand by notice in writing all amounts and liabilities paid or payable or suffered or incurred by you on account of any of the aforesaid matters as certified by you in such notice forthwith and it shall not be necessary for you to first have recourse against clients handled or referred by me and I agree that all amounts and liabilities as demanded by you shall be conclusive and binding upon me in the absence of manifest error.

I agree that this Indemnity shall continue to be valid and subsisting notwithstanding the termination of my aforesaid engagement until all future contract transactions

handled or referred by me have been properly completed and settled to your satisfaction. I also agree that the Company shall have a right to withhold all or part of my remuneration in the event of any dispute or claim on any transactions handled of (sic) referred by me.'.

5. By virtue of the Indemnity, the Taxpayer had to indemnify Company K against all non-payments of the clients who were handled or referred by him and against any loss or damage resulted from his negligence in carrying out his duties. Further, under both the Indemnity and the Letter of Employment, any loss or damage suffered by Company K as a result of errors committed by the Taxpayer in the dealing activities was to be borne by the Taxpayer.

6. Under the Employment, the Taxpayer was entitled to 50% of the commission earned by him (net of rebates). This Board believes that the high earning of the Taxpayer (in terms of his share in the commission), viewed in the context of his liabilities over non-payments and dealing errors, gives a true flavour of the nature of the Employment. A proper understanding of the nature of the Employment will provide an important key to resolving the issues before this Board.

7. Although the Taxpayer was an employee of Company K, he was plainly assuming considerable risks in carrying out each and every dealing instruction of 'his clients' (those handled or referred by him) in that, at the very least, he would be responsible for any 'bad debts' arising from such transactions. This assumption of responsibility on the part of the Taxpayer reflected his share in the commission. By the same token, in agreeing to an equal sharing of the commission, Company K did not have to shoulder the credit risks of the Taxpayer's clients or even the risks arising from the negligence of the Taxpayer.

8. During the two assessment years in question, the lion portion of the Taxpayer income was derived from commission earned. However, during those years, a number of his clients failed to settle their outstanding accounts with Company K which led to the creation of three Agreements, two of which were dated 6 February 2001 and one dated 28 May 2001, made between the Taxpayer and Company K. Under each of these Agreements, the Taxpayer, in satisfaction of his obligations under the Indemnity, undertook to pay Company K a sum which was made up of outstanding debts of his clients. In two of these Agreements, there was an acknowledgement of partial payment by the Taxpayer.

The issues

9. Mr Chan, who appears for the Taxpayer, has informed this Board that the Taxpayer abandons his claims on deduction in respect of Interest and Phone line expenses for the year 2001/02 [see paragraph 1(11)(b) of the Determination at B1/11]. Further, Mr Chan takes no issue with the minor arithmetical error referred to in paragraph 1.3 of the 'Submission by the Commissioner's representative' ('the IR's Submissions').

10. There are two issues before this Board. Firstly, whether the payments made by the Taxpayer to Company K pursuant to the Indemnity to settle the debts of his defaulting clients are deductible under section 12(1)(a) of the Inland Revenue Ordinance, Chapter 112 ('IRO'). Secondly, the quantum of deduction to be made, if the said payments can be deducted, for the assessment years in question.

Section 12(1)(a)

11. Section 12(1)(a) governs the deduction of expenses for salaries tax purposes and provides as follows:

> '*(1) In ascertaining the net assessable income of a person for any year of assessment, there shall be deducted from the assessable income of that person –*
>
> *(a) all outgoings and expenses, other than expenses of a domestic or private nature and capital expenditure, wholly, exclusively and necessarily incurred in the production of the assessable income;*'.

12. Mr Chan submits to this Board, and there is no quarrel from Mr Chow and Ms Wong who appear for the Inland Revenue ('IR'), that in order to be deductible the expenditure in question has to be:

(i) Incurred in the production of the assessable income;

(ii) wholly and exclusively so incurred; and

(iii) necessarily so incurred.

13. The IR takes issue with all three of these elements in respect of the deduction in question. Notwithstanding the adversarial system under which these matters are to be resolved, this Board is a little surprised by the stance taken by the IR bearing in mind that (a) in the Determination the matter was decided against the Taxpayer based on the 'necessity' requirement alone and (b) not all of the 'additional' arguments are meritorious.

14. Before dealing with the submissions under each of the elements, this Board reminds itself that the provisions of section 12(1)(a) are notoriously rigid, narrow and restricted in their operation. Further, deductions under salaries tax are considerably more restrictive than those under profits tax. In this case, Mr Chow accepts that if deductions were claimed by Company K in respect of the bad debts in question ('the Bad Debts') under profits tax, there would have been no argument. However, the Legislature has seen fit to impose different statutory regimes for profits tax and salaries tax and the function of this Board is to resolve these matters according to the law.

Wholly and exclusively incurred

15. It is convenient for this point to be dealt with first. With respect, this Board sees no merits in the IR's submissions. Two arguments are advanced by the IR. Firstly, it is submitted that 'there is no evidence showing that the [Bad Debts] were wholly and exclusively incurred in the production of the [Taxpayer's] assessable income' [paragraph 6.26 of the IR's Submissions]. Given that there is no factual dispute in this case, this Board is simply unable to see any substance in this point. Indeed, Mr Chow is unable to tell this Board what evidence is lacking.

16. Secondly, Mr Chow submits that the Bad Debts were incurred by the Taxpayer for purposes of securing the Employment or in discharge of a contractual liability. Such submission, this Board believes, is based on the notion that expenditure might have been incurred for more than one purpose and no deduction can be allowed unless the expenditure was incurred wholly and exclusively in the production of assessable income. For instance, expenditure on clothing was disallowed for failing to meet that requirement (see Mallalieu v Drummond [1983] STC 665).

17. It is not correct to say that the Bad Debts were incurred for purpose of securing the Employment. It was a term of the Employment that the Taxpayer had to provide Company K with an indemnity. However, at the time of obtaining the employment there was no bad debt. Whilst it is true that the Bad Debts were incurred in the discharge of a contractual liability (owed to Company K), this Board finds that the IR's submission is somewhat detached from reality.

18. The law must be applied with common sense and a proper appraisal of the facts. This Board takes the view that, on proper analysis, on each occasion when the Taxpayer carried out the instructions of his clients he incurred a contingent liability under the Indemnity in respect of potential non-payment by the clients. To his misfortune, some of these contingent liabilities materialised. It is unrealistic to suggest that the Bad Debts were incurred for any purpose other than the production of the Taxpayer's assessable income. This Board is in no doubt that the submissions of the IR under this head must be rejected.

Incurred in the production of assessable income

19. Mr Chow submits that any allowable deduction has to be incurred in the production of the assessable income. He refers this Board to Humbles v Brooks 40 TC 500 at page 502, where it was held that:

> '*"In the performance of the said duties' means in the course of their performance… It means 'in doing the work of the office, in doing the things which it is his duty to do while doing the work of the office" … It does not include qualifying initially to perform the duties of the office, or even keeping*

qualified to perform them ... it does not mean adding to the taxpayer's usefulness in performing his duties.'.

It is trite that the difference in wording in the UK provision is immaterial.

20. Mr Chow also relies on D36/90, IRBRD, vol 5, 295 where the Board cited with approval the holding in Rickets v Colquhoun [1926] AC 1 that 'in the performance of the duties' meant 'in the course of the performance of the duties and not before or after the performance'.

21. Based on these authorities, Mr Chow submits that the performance of the Taxpayer's duties as a dealer was a 'separate process' to the occasion of the Bad Debts, which were due to the non-payment of the clients. The Bad Debts were not connected with the Taxpayer's duties. In response to the suggestion that each 'trading' made by the Taxpayer on behalf of his client was attached with a contingent liability on the Taxpayer by virtue of the Indemnity, Mr Chow submits that contingent liability is not relevant and it is 'expenditure' that is relevant. He goes as far as submitting that a crystallised contingent liability can never be deductible.

22. Further, Mr Chow relies on D36/90 and CIR v Burns 1 HKTC 1181 and submits that the Bad Debts were incurred 'for placing the [Taxpayer] in a position (that is, obtaining the employment) in which he was able to earn the assessable income (that is, the commission income), but not expenses incurred in the production of the assessable income' [paragraph 8 of the 'Supplementary submission by the Commissioner's representative'].

23. D36/90 concerned a case where the taxpayer was employed as a mamasan of a nightclub. Her job was to provide hostesses to entertain the customers of the nightclub and she had to lead a group of the hostesses. She claimed deduction over a host of expenses including entertainment expenditure, the cost of renting and running her residence which was used partly as the resting place for the hostesses and the salaries paid to an assistant hired for helping the taxpayer in her work. The Board held that 'with the possible exception of entertainment expenses (which in fact have not been proved), the expenses were not incurred in the course of performance of her duty of providing customers with hostesses, but merely for the purpose of producing income'.

24. In CIR v Burns, a racehorse trainer claimed deduction of legal expenses he incurred in an appeal against disqualification. The claim was rejected by the court. It was held that a distinction should be drawn between an expense incurred in gaining income and one incurred necessarily for the purpose of seeing that the taxpayer was not precluded from earning his assessable income and were not incurred in the production of it.

25. This Board is grateful for the assistance rendered by Mr Chow in citing to it the guiding authorities. The relevant principles must be borne in mind. However, cases are rarely identical on facts and the principles must be applied to the facts sensibly.

26. This Board is unable to accept the submission that the performance by the Taxpayer of his duties under the Employment was divorced from the Bad Debts. In order to earn the commission (produce the assessable income), the Taxpayer had to incur the contingent liability. There was always a possibility that the contingent liability would crystallise and such crystallisation did not change the fact that the earning of the commission went hand in hand with the contingent liability. Where the contingent liability had materialised, like the present case, such liability (subject to any other arguments) must be deductible against the assessable income. Where the contingent liability did not materialise, there was simply nothing to be deducted.

27. None of the authorities cited to this Board concerned a deduction which could be traced to a contingent liability. However, based on the foregoing analysis, this Board does not agree with the submission that a crystallised contingent liability can never be deductible.

28. This Board also rejects the argument that the Bad Debts were incurred for the production of assessable income rather than in the production of assessment income [see paragraph 22 above]. This point was touched upon in paragraphs 16 to 18 above. Based on the analysis set out in paragraph 26 above, it is a distorted perception of the facts to suggest that the Bad Debts were incurred for the production of assessable income.

Necessarily incurred

29. Mr Chan submits that a summary of the authorities in relation to this element can be found in D7/04, IRBRD, vol 19, 93 at pages 100-101. Mr Chow does not quarrel with that summary, which is set out and adopted below:

> ‘ *Case law has established the following principles/tests on "necessarily in the performance of the duties":*
>
> *(a) "In the performance of the duties" means in doing the work of the office, in doing the things which it is his duty to do while doing the work of the office. (Nolder v Walters (1930) 15 TC 380 – quoted in Baird v Williams [1999] STC 635 at 641)*
>
> *(b) Expenditure may be "necessary" for the holder of an office without being necessary to him in the performance of the duties of that office. (Lomax v Newton (1953) 34 TC 558 – quoted in Baird v Williams [1999] STC 635 at 640)*
>
> *(c) Something that is directly referable to carrying out a duty need not be necessary for performing that duty. (Baird v Williams [1999] STC 635 at 642)*

(d) *The test for necessity is an objective one. The test is not whether the employer imposes the expense, but whether the duties do, in the sense that irrespective of what the employer may prescribe, the duties cannot be performed without incurring the particular outlay. (Brown v Bullock (1961) 40 TC 1 at 10)*

(e) *The language of the rule points to the expenses with which it is concerned being only those which each and every occupant of the particular office is necessarily obliged to incur in the performance of its duties – namely, to expenses imposed upon each holder ex necessitate of his office, and to such expenses only. The terms employed are strictly, and purposely, not personal but objective. The deductible expenses do not extend to those that the holder has to incur mainly and, it may be, only because of circumstances in relation to his office that are personal to himself or are the result of his own volition. (Ricketts v Colquhoun (1926) 10 TC 118 at 135)*

(f) *The existence of personal choice and benefit is a strong indicator that it is not objectively necessary for the employee to incur the expenditure for the purpose of carrying out his duties. (Baird v Williams [1999] STC 635 at 641)*'.

30. The opposing arguments are well confined. On one hand, Mr Chan relies heavily on the fact that the Taxpayer was obliged under the terms of the Employment to pay for the Bad Debts. On the other hand, Mr Chow maintains that contractual obligation is irrelevant and that the question is whether the Taxpayer's duties could not be performed without incurring the Bad Debts [paragraph 6.14 of the IR' s Submissions].

31. In addition, Mr Chow submits that the Bad Debts might have been incurred 'in respect of losses as a result of the [Taxpayer' s] defaults in carrying out his duties (for example admitting a client that he should not admit or not complying with rules and regulations laid down by [Company K]). In that case, the payment of the [Bad Debts] "was not for the performance of such duties [of the [Taxpayer]] but for deviation from such duties." (see D35/04, ..)' [paragraph 6.15 of the IR' s Submissions].

32. Dealing firstly with Mr Chow' s second point, the authority of D35/04, IRBRD, vol 19, 295, concerned a factual matrix which is not entirely different to that before this Board. The taxpayer in that case was employed by, apparently, a securities company as its Assistant Vice President. A substantial part of his income was made up of commissions which were apparently earned via trading made by the taxpayer on behalf of clients. It was a term of his employment contract that he had to compensate his employer for bad debts and error deals resulting from his failure to comply with his employer' s credit control policy and procedure. As a result of such a

failure, the taxpayer agreed to make compensation to his employer and the issue before the Board was whether such compensation was deductible under section 12(1)(a) of the IRO. It was held that the taxpayer' s 'incurrence of personal liability was not for the performance of [his] duties but for the deviation from such duties' and the claimed deduction was rejected.

33. With respect, there is no factual basis on which Mr Chow can launch his second point. No doubt with D35/04 in mind, a representative of the IR had on the 25 August 2005 written to Company K putting to it squarely questions which would have elicited information over any failure to comply with its rules and regulations and the like on the part of the Taxpayer [R1/61]. The enquiries were answered in the negative [R1/66]. It is regrettable that the IR sees fit to take this point without proper basis and it is rejected.

34. In respect of the relevance of the terms of the Employment, this Board is of the opinion that it is wrong to ignore the same given that the deduction in issue arose from the terms of the Employment. Some guidance can be gained from the House of Lords authority of Taylor v Provan [1975] AC 194. In that case, it was held that a taxpayer resident in Canada, who made a speciality of takeovers and mergers in the brewing industry, could deduct the cost of air passages to and from the United Kingdom and Toronto where he performed the main part of his duties. The court reached this decision because he had two places of work and because the work entailed was of a specialist nature that could be done by no one else.

35. At pages 227E-H, Lord Salmon stated that:

> ' *In my view, the only possible inference from the primary facts as found in the present case ... is that the places in which Mr Taylor was required to work were Toronto and Nassau as well as the United Kingdom. This was spelt out in the terms of his employment .... When you are considering where the duties of a man' s employment require him to work, you look first at the terms of his employment. These normally are conclusive. A term which may appear to be rather more for the man' s benefit than for the benefit of his employers is still a term of the employment. The fact that you may suspect that the employers might waive it is, in my view, irrelevant.*
>
> *I am not suggesting that the terms of employment are conclusive in every case. It is easy to imagine a case in which, for instance, an English resident employed by an English company as a director to do work unconnected with France has a term inserted in his contract which provides that he shall do part of his work in an hotel on the French Riviera and that his employers shall pay all the expenses involved, including travelling expenses. This would obviously be colourable – a mere device to satisfy his wish to spend some time in the sun with his expenses paid tax free. The term could be of no benefit to the*

> *company which he serves and the job could, no doubt, be filled by persons of no less competence but less greed.*'.

36. At pages 218A-B, Lord Wilberforce, who was one of the dissenting Law Lords, stated that:

> '*If, as I believe to be the law, expenses incurred on account of personal circumstances are not deductible under the rule, they cannot be made so merely by the technique, or device, of injecting them into the contract of employment. To hold that they could, would invite the creation of arrangements which might not correspond with reality and which would produce gross inequality of treatment. The commissioners must always have the right to examine the whole circumstances and to decide what, objectively, the duties of the office or employment were and what was necessary in their performance.*'.

37. Bearing in mind the aforesaid, this Board takes the view that the terms of the Employment constitute a relevant consideration for purpose of deciding whether the Bad Debts were necessarily incurred in the production of the Taxpayer's assessable income. They are not conclusive and this Board should be alive to any suggestion that the terms did not reflect a genuine bargain between the Taxpayer and Company K. There is of course no such suggestion here.

38. Mr Chow relies heavily on the principle adumbrated in the well-known authority of Brown v Bullock 40 TC 1 that necessity turns on whether the duties of the taxpayer cannot be performed without incurring the particular outlay. Mr Chow was at pains to emphasize that the Taxpayer was able to perform his duties without having to meet the Bad Debts. The obligation to meet the Bad Debts was the result of default by the Taxpayer's clients.

39. The principle laid down in Brown v Bullock must be understood against the factual matrix of that case. In that case, the court rejected a claim for deduction in respect of club membership expenditure notwithstanding that the taxpayer's appointment as bank manager was subject to a prerequisite imposed by his employer that he joined a certain club. The *ratio* was that the club membership was not necessary for the performance of the taxpayer's duties.

40. This Board believes that the resolution of this issue turns on an application of the law with a proper understanding of the nature of the Employment. What did it call for, or involve, in the way of duties? Much has been already said about what this Board believes to be the proper understanding. In order to earn that high level of commission, the Taxpayer had to bear the risk of bad debts. In other words, without incurring the risk the Taxpayer would not have been able to gain his share of the commission. They can be seen to be the two sides of a coin. It seems to be illogical for the IR to contend that the Taxpayer should be liable for tax on his high level of commission but at the same time refused any deduction when the risk had materialized. This Board

is satisfied that the Bad Debts were necessarily incurred in the production of the Taxpayer's assessable income.

41. For completeness, it should be mentioned that there is no evidence before this Board as to how common it was for employees in the securities trade to be required to provide an indemnity to their employers in terms similar to the Indemnity. Mr Chan fairly accepts that he is in no position to adduce such evidence and Mr Chow has declined the invitation to enlighten this Board on the matter.

42. Under the principle set out in paragraph 29(e) above, if there were evidence that an indemnity in favour of employers was commonplace, such evidence may assist this Board to resolve the issue under this head. On the other hand, this Board is of the view that this is only one of the considerations and the absence of such evidence does not detract this Board from its conclusion.

Quantum of deduction

43. There is no dispute between the parties that between the period of 18 February 2000 and 18 April 2002 (both dates included) a total sum of HK$2,649,484.35 had been paid by the Taxpayer to Company K pursuant to the Indemnity on five occasions involving the outstanding accounts of 10 clients [see paragraph 1(10)(e) of the Determination at B1/10]. To be precise, the payments were effected by way of set-off against moneys owed to the Taxpayer by Company K which were deposited in a suspense account.

44. The IR contends that the legitimate amount of deduction for the years 2000/01 and 2001/02 are respectively HK$612,175 and HK$1,449,078 based on the dates on which the various sums were actually set-off against the money held in the suspense account. Mr Chow submits that the 'expenses' in question cannot be regarded as 'incurred' before the set-off, because the debts might not be irrecoverable and further recovery action might still be taken against the debtors. Mr Chow points to the debts owed by one of the clients by the name of CT and demonstrates that between the time of the Agreement under which the Taxpayer agreed to indemnify Company K (6 February 2001) ('the Agreement') and the time of set- off (28 May 2001) CT had apparently paid a substantial portion of the money he owed. Such payment by CT is conceded by Mr Chan. Ms Wong, who was given leave to address this Board, adds that the debts covered by the Agreement might not be required to be set-off against the money in the suspense account, because the clients might have, for example, shares pledged with Company K which could be realised in satisfaction of the debts.

45. On the other hand, Mr Chan contends that this issue should be resolved in accordance with the established principles set out in paragraph 2-5150 of Hong Kong master tax guide 2004/05 by CCH Asia Pte Ltd:

"INCURRED" DEFINED

> Only an established liability, or a definite commitment, arising in the year of assessment in which a deduction is sought, is considered to have been *incurred* in the production of assessable income in that year. It is not essential that any payment actually be made during a year of assessment. Rather, if an actual and known liability of an ascertainable amount exists on the last day of the year of assessment, a deduction will be allowed. An anticipated future outgoing or expense, however, is insufficient to qualify for deduction.'.

Mr Chow accepts those principles.

46. In applying those principles, Mr Chan submits that the liability to indemnify Company K crystallised upon entering into the three Agreements (see paragraph 8 above) and was 'incurred' for purposes of section 12(1)(a). He further submits that any excessive deduction can be reversed in the next tax year.

47. This Board accepts the invitation of Mr Chan, despite the opposition of Mr Chow, to rule upon this issue as a matter of principle and leave the details to be resolved between the parties in accordance therewith.

48. This Board sees no reason not to apply the undisputed principles to these matters and holds that the deduction on account of the Bad Debts is to be calculated in accordance with the dates of the three Agreements as submitted by Mr Chan.

49. Again for completeness, the IR contends that there is insufficient evidence to the effect that the Bad Debts were irrecoverable [paragraph 6.7 of the IR's Submissions]. With respect, this Board sees nothing in this point. There is no suggestion that the agreement by the Taxpayer to indemnify Company K was anything but genuine. It is a matter of common sense, and this Board so infers, that the Taxpayer would not have agreed to pay Company K over HK$2,600,000 if he believed that the Bad Debts were recoverable from his clients.

Conclusion

50. For these reasons, this appeal is allowed, the Determination is annulled and these matters are remitted back to the Commissioner of IR for re-assessment of the salaries tax in question in accordance with this decision.