INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D61/91

Profits tax – professional practice – whether management fees paid to company owned by taxpayer can be deducted. Sections 16(1) and 17(1)(a) of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Ma Ching Yuk and Alexander Woo Chung Ho.

Date of hearing: 24 October 1991.
Date of decision: 9 January 1992.

The taxpayer was a dentist who had formed a company owned beneficially by himself and which was paid a substantial fee called a management fee. The taxpayer claimed that the entire management fee was deductible as an expense of the practice of a dentist which he carried on. The assessor refused to allow deduction of the entirety of the fee paid to the company. The taxpayer appealed to the Board of Review and argued that the entire fee was deductible and had been incurred in the production of the assessable profits. The fee included such items as club subscriptions and dues, interest on a mortgage loan to purchase residential accommodation used by the taxpayer for his own purposes, motor car running expenses, etc.

Held:

That subject to certain expense items which the Commissioner accepted as relating to the business of the taxpayer, the appeal was dismissed. An expense can only be deducted from taxable profits to the extent to which it is incurred in the production of those taxable profits. A fee paid to a third party can only be deducted to the extent that the fee relates to services provided to enable the taxpayer to earn the taxable profits.

Allowed in part.

[Editor's note: The taxpayer has filed an appeal against this decision.]

Cases referred to:

Re Euro Hotel (Belgravia) Ltd 51 TC 293
Jeffrey v Rolls Royce Ltd 40 TC 494
Henley v Murray 31 TC 351
Lo & Lo v CIR 2 HKTC 34
CIR v Swire Pacific Limited HKTC 1145

Bentleys, Stokes & Lowless v Beeson 33 TC 491
Strong and Company of Romsey Limited v Woodifield 5 TC 215
Ransom v Higgs 50 TC 1
Mackinlay v Arthur Young McClelland Moores & Co [1989] STC 898
Copeman v William Flood & Sons Ltd 24 TC 53
D69/90, IRBRD, vol 5, 485

S P Barns for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

This is an appeal by a taxpayer carrying on business as a dentist who claimed to be able to deduct certain management fees from his taxable income. The facts are as follows:

1. The Taxpayer carried on business as a dental surgeon and commenced business in early 1984. It is the profits of this business which are the subject matter of this appeal and for convenience and clarity we refer to the business as 'the practice'.

2. Profits tax returns were issued to the Taxpayer in respect of the practice for the years of assessment 1984/85 to 1988/89 inclusive. In the absence of tax returns, the assessor raised estimated assessments on the Taxpayer in respect of each of the five years in question. The Taxpayer through his tax representatives lodged objections to the five estimated assessments as they were made in respect of each year on the ground that the same were excessive. The Taxpayer filed income statements for the practice in support of the objections as they were lodged. Details of the income statements are as follows:

	For year ended 31 March				
	1985 $	1986 $	1987 $	1988 $	1989 $
Income	902,177	932,247	952,333	1,133,022	1,233,160
Expenses					
Management fee	900,000	940,000	1,100,000	1,100,000	1,097,512
Bad debts	3,260	2,110	13,518	12,996	2,550

Laboratory expenses					64,663
Legal and professional fee					960
Medical					4,856
Dental supplies					18,692
Printing and stationery					2,230
Uniforms					2,730
	903,260	942,110	1,113,518	1,112,996	1,194,193
Profits (Loss) for the year	(1,083)	(9,863)	(161,185)	20,026	38,967

3. The management fees were paid by the Taxpayer to a management company which was beneficially owned by and controlled by himself. There was no written contract between the Taxpayer and the management company.

4. The management fees were paid in respect of services rendered by the management company to the practice comprising the provision of clinic space, office equipment, supporting staff and various general and administrative services. The supporting staff comprised the services of one nurse. The clinic space and equipment included the furniture, fixtures and equipment, tables, seats, reception counter and cabinets, carpets, partitioning and other furnishing work. In addition, the management company provided the practice with all of the necessary dental equipment from loose drills and pluggers to the sophisticated dental x-ray apparatus.

5. In addition to providing his professional services as a dentist to the practice, the Taxpayer was employed by the management company to provide certain services to the practice in the form of checking the supply of consumables such as oxygen and dental alloy and ordering and replenishing the inventory as appropriate. The management company was responsible for keeping the books and records of the practice and handling all routine clerical work for the practice. No evidence was given as to who provided this service. As the management company only had available to it the services of one nurse and the

Taxpayer, it is presumed that the book-keeping, record-keeping and clerical work were handled by these two persons as employees of the management company.

6. The management fee was calculated and paid as a lump sum fee. It was agreed or determined by the Taxpayer on behalf of the practice and the management company. The Taxpayer stated, but the Board does not accept, that the quantum of the fee was based on the quality and quantity of the services provided by the management company to the practice. The management fee was determined by the Taxpayer and paid on an annual basis. The Taxpayer stated that in respect of the initial years the management fee agreed or fixed between himself and his management company was less than the expenses of the management company but that in subsequent years, the management fee was based on the expenses of operating the management company plus a small profit. In deciding the management fee the Taxpayer took into account what he perceived to be the guidelines of the Inland Revenue Department.

7. The profit and loss accounts of the management company for the years in question were as follows:

	1984 $	1985 $	1986 $	1987 $	1988 $	1989 $
Management fee income	600,000	900,000	940,000	1,100,000	1,133,022	1,097,512
Other income	15,300	-	-	-	-	-
	615,300	900,000	940,000	1,100,000	1,133,022	1,097,512
Less: General and Administration Expenses						
Auditors' remun-eration	5,070,	5,500	5,500	5,500	6,000	7,000
Advertis-ing	-	-	-	-	4,079	4,362
Account-ancy fee	4,000	4,000	-	-	828	-
Bank						

interest and charges	899	72,034	48,090	7,279	55,416	72,624
Building manage-ment fee	-	-	-	-	-	5,760
Cleaning and sanitary	1,402	7,788	10,224	1,203	6,738	6,110
Club sub-scription & due	29,502	33,429	38,028	1,221	-	-
Computer expenses	120	982	1,485	-	-	-
Directors emolu-ments	122,834	108,000	94,000	96,000	96,000	96,000
Depreciat ion	93,203	153,703	161,882	161,882	124,741	87,886
Education	18,905	35,780	22,703	28,965	27,480	-
Entertain-ment	36,220	66,967	78,358	167,420	205,932	140,220
Household expenses	-	-	-	-	-	4,004
Insurance	10,814	26,567	9,721	10,974	9,298	9,500
Legal and profess-ional fee	46,243	17,776	4,101	18,520	6,245	19,231
Medical & dental benefits	2,185	20,763	27,809	15,362	-	-

Medical & dental supplies	-	-	-	-	20,689	-
Miscellan-eous expenses	11,933	20,310	28,454	9,040	26,702	32,181
Mortgage loan interest	334,138	309,150	197,082	167,326	155,854	178,407
Motor car running expenses	17,324	7,319	8,330	17,582	9,615	45,361
Newspapers & books	1,491	3,762	9,541	860	2,846	157
Office refresh-ment	-	-	971	-	367	-
Pest control	-	-	-	-	-	1,300
Rents and rates	15,875	129,863	144,833	15,840	156,776	179,036
Repairs and main-tenance	2,272	16,401	18,692	21,979	15,288	600
Salary	16,200	62,308	45,218	40,946	71,929	98,194
Staff welfare	74,105	33,918	35,983	6,922	667	2,768
Telephone and telex	940	9,468	13,155	1,056	25,487	5,081
Travelling expenses	48,829	23,883	30,388	25,198	36,896	57,247

Utilities	22,074	15,852	16,616	14,810	11,779	18,611
Commission	-	3,700	9,450	5,600	6,012	22,815
Laboratory expenses	-	54,654	126,760	137,136	75,405	-
Postage, printing & stationery	-	8,861	13,417	7,803	5,029	5,370
Decorations	-	11,957	132,047	57,140	4,655	4,860
	916,578	1,264,695	1,332,838	1,043,564	1,168,753	1,104,685
PROFIT (LOSS) FOR THE YEAR	(301,278)	(364,695)	(392,838)	56,436	(35,731)	(7,173)

Small charges in the description of expense items appeared between the early years and later but with two possible exceptions. The changes do not appear to be material and have not been itemised above. For example in early years, the item 'cleaning and sanitary' appears to have been described as 'clothing and laundry'. The two exceptions relate to 'medical & dental benefits' and 'club subscription and due'. In the year 1989 these items were reclassified as 'medical & dental supplies' and 'entertainment'. No explanation was given regarding this reclassification.

8. The management company filed with the Inland Revenue Department an employer's tax return in respect of the Taxpayer in which the directors' emoluments were duly declared and it was stated that the management company as employer of the Taxpayer provided the Taxpayer with quarters being a house owned by the management company. The house which was occupied by the Taxpayer was purchased by the management company under mortgage and one of the major expenses of the management company was the mortgage interest which it paid in respect of the mortgage on this house. No mention was made of any other benefits paid or provided to the Taxpayer by the management company.

9. The assessor was of the opinion that 'some expenses claimed by [the management company] appeared not to correspond to or reflect the services

claimed to be provided to the [practice]'. He was further of the opinion that some of the expenses 'had not been incurred for the purpose of or in the production of assessable income of the [practice]'. The assessor requested further information with regard to the management fee including a request for details of the method of payments of the management fee for each of the five years in question together with supporting evidence. In default of any satisfactory reply, the assessor submitted the objections which had been filed by the Taxpayer against the estimated assessments to the Deputy Commissioner for his determination.

10. The Deputy Commissioner by his determination dated 10 May 1991 decided that the management fee claimed as deductible by the Taxpayer from the profits of the practice was not a management fee and was not allowable as a deduction from the taxable profits.

11. Having decided that the management fee was not a management fee, the Deputy Commissioner reached the following conclusion:

> ' I conclude that the character of this item can only be ascertained by a consideration of the items claimed as a deduction in the returns for [the management company]. When I look at these returns I find that there are claims for deductions for items that are clearly:
>
> (i) domestic or private expenses; and/or
>
> (ii) expenses not wholly and exclusively incurred in the production of profits.'

The items that I regard as fitting into this category are set out below:

	1984/85 $	1985/86 $	1986/87 $	1987/88 $	1988/89 $
Club subscription and due	33,429	38,028	1,221	-	-
Entertainment	66,967	78,358	167,420	205,932	140,220
Medical & dental benefits	20,763	27,809	15,362	-	-
Mortgage loan interest	309,150	197,082	167,326	155,854	178,407
Motor car running	-	-	-	-	35,856

expenses					
Travelling expenses – overseas	22,973	22,180	25,198	33,946	46,018
Education	35,780	22,703	-	-	-
Salary expenses	31,108	14,018	-	28,929	34,694
Total disallowable expenses	520,170	400,178	376,527	424,661	435,195

The effect of this is that the claim for a deduction for 'management fee' fails to the extent set out above under the heading 'total disallowable expenses' for each year.

The profit/loss returned by the (practice) for each year is therefore revised as follows:

	1984/85 $	1985/86 $	1986/87 $	1987/88 $	1988/89 $
Returned (Loss)/ Profit	(1,083)	(9,863)	(161,185)	20,026	38,967
Total disallowable 'Management Fee'	520,170	400,178	376,527	424,661	435,195
Revised Assessable Profit	519,087	390,315	215,342	444,687	474,162
Tax Rate	17%	17%	17%	16.5%	15.5%
Tax Payable	$88,244	$66,353	$36,608	$73,373	$73,495

12. The Deputy Commissioner ordered that the tax assessments against which the Taxpayer had appealed should be reduced or increased accordingly.

13. The Deputy Commissioner added at the end of his determination two further findings, one to the effect that the management fee was not solely for business purposes or for the production of profits and that he was not satisfied that the management fee had actually been incurred. The relevant part of his determination reads as follows:

‘(6) I cannot leave this question without referring in greater detail to rule 2A(2) of the Inland Revenue Rules as set out above and in particular to the “exclusively” requirement of that rule. In interpreting the same requirement under the English Rules Romer L J said in the Court of Appeal in Bentleys, Stokes & Lowless v Beeson 33 TC 491 at pages 503, 504:

> “The relevant words of paragraph 3 (a) of the rules applicable to cases 1 and II – wholly and exclusively laid out or expended for the purposes ‘of the profession’ – appear straightforward enough. It is conceded that the first adverb – ‘wholly’ – is in reference to the quantum of the money expended and has no relevance to the present case. The sole question is whether the expenditure in question was ‘exclusively’ laid out for business purposes, that is: What was the motive or object in the mind of the two individuals responsible for the activities in question? It is well established that the question is one of fact: and again, therefore, the problem seems simple enough. The difficulty however arises, as we think, from the nature of the activity in question. Entertaining involves inevitably the characteristic of hospitality. Giving to charity or subscribing to a staff pension fund involves inevitably the object of benefaction. An undertaking to guarantee to a limited amount a national exhibition involves inevitably supporting that exhibition and the purposes for which it has been organised. But the question in all such cases is: Was the entertaining, the charitable subscription, the guarantee, undertaken solely for the purposes of business, that is, solely with the object of promoting the business or its profit-earning capacity?
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> It is, as we have said, a question of fact. And it is quite clear that the purpose must be the sole purpose. The paragraph says so in clear terms. If the activity be undertaken with the object both of promoting business and also with some other purpose, for example, with the object of indulging an independent wish of entertaining a friend or stranger or of supporting a charitable or benevolent object, then the paragraph is not satisfied though in the mind of the actor the business motive may predominate. For the statute so prescribes. Per contra, if in truth the sole object is business promotion, the expenditure is not disqualified because the nature of the activity necessarily involves some other result, or the attainment or furtherance of some other objective,

since the latter result or objective is necessarily inherent in the act." (underlining supplied)

Applying the same approach in this case in relation to the 'management fee', I can only say that it is impossible for me to conclude that the sole purpose of paying the relevant part of the so-called management fee as set out above for each year in (fact 11 above) was for business purposes or in the production of profits. Rather, I would conclude that if there was a sole purpose, that purpose was a vain attempt to obtain a tax deduction for expenses which were domestic or private in nature.

Last, but not least, I note that when the assessor sent a preliminary statement of facts to the representative and Taxpayer for comments, he asked for evidence in respect of the method of payment of the 'management fee' to [the management company] for each of the five years ended 31 March 1989. However, no such evidence was forthcoming. In this circumstances I cannot even be satisfied that the 'management fee' was an outgoing or expense incurred in terms of subsection 16(1) of the Inland Revenue Ordinance.'

14. The Taxpayer appealed against the determination of the Deputy Commissioner and the matter duly came before this Board of Review.

At the hearing, the Taxpayer appeared on behalf of himself and the Commissioner was represented by his senior assessor. This appeal raises a number of very interesting and important questions and we would like to express our appreciation to both the Taxpayer and Mr Barns, the senior assessor, who appeared before us for the clear and understanding way in which they put before us the questions to be decided by us. It is surprising that this is apparently the first case of this type to be taken on appeal to the Board of Review. Similar circumstances must be an almost daily occurrence in Hong Kong and as we said to the parties when they appeared before us, we are mindful that our decision in this case will not only be of great interest to them but also to many other taxpayers and their advisors in Hong Kong as well as the Commissioner and his staff.

The Taxpayer elected to give evidence and offered himself for cross-examination. There are two facts which we would like to deal with separately at the beginning of our decision and explain our reasoning because they both, to a greater or lesser extent, have a bearing on our decision.

The first point is the final statement of the Deputy Commissioner in his determination when he said that he was not satisfied that the practice had actually incurred the management fee. (fact 13 above). With due respect to the Deputy Commissioner, we feel that perhaps this statement might better have been left out of his determination, or alternatively, substantiated in some forms by him. It was not a point which his representative took at the hearing of the appeal. In so far as it might be material, we have found in the facts above stated that the management fee was paid on an annual basis, (facts

3, 4 and 6 above). This is in accordance with the submissions to the Commissioner made by two different firms of professional tax representatives, and in accordance with the apparently audited accounts of the management company which in respect of most of the years in question have already been accepted by the Commissioner and have formed the subject matter of tax assessments or loss computations. The Taxpayer gave evidence and offered himself for cross-examination and was not cross-examined with regard to this. He said in his evidence that the management fee had been calculated and paid each year. In such circumstances, we have no hesitation in finding as a fact and as we have done above that the management fees were incurred.

The second point is in relation to the contract between the management company and the practice of the Taxpayer. This was not at first put in writing and apparently was never reduced into writing because no written agreement was tabled before the Board. The Taxpayer in giving evidence said that he thought that a written agreement had been prepared by his tax advisors but could not be certain with regard to this. We have found as a fact that the agreement was never reduced into writing. (fact 3 above). With regard to the nature of the verbal agreement, we have made findings of fact. (facts 4 and 5 above). The services provided by the management company are reasonably clear and precise. They all had a direct relationship to the business of the practice. However what is not so clear is the nature and substance of the management fee paid by the practice to the management company and we shall deal with this later in our decision. For convenience, we have used in this decision the designation ‘management fee’. We agree with the Deputy Commissioner, his assessor and his representative when they have decided or submitted that by describing a payment with a particular title, it does not mean that the payment has that meaning. Perhaps the fee could more appositely have been designated service fee or fee for services. However, the expression 'management fee' is often used in the course of business to describe a fee paid for services which may include a managerial content. It was not claimed by the Taxpayer that the fee was paid to the management company so that the management company would manage the Taxpayer when he was performing his professional services as a dentist, but the services did include a managerial element with regard to the non-professional areas of the practice.

Having dealt with these two preliminary points of fact, we now summarise the submissions made before us. The Taxpayer addressed us with regard to the two items entitled ‘education’ and ‘travelling expenses’ which he said had been discussed between him and the representative for the Commissioner. He explained that the Commissioner had originally taken the view that the education had been part of his family expenses and likewise the travelling expenses had not related to the practice but to his family. He explained that the education and travel both related to the practice. This was accepted by the representative for the Commissioner subject to a dispute relating to the quantum of the travelling expenses. The Commissioner’s representative said that he had not received documentary evidence to prove that all of the travelling expenses had been incurred in the business of the practice. In giving evidence the Taxpayer dealt with this matter and satisfied the Board that all of the travelling expenses related to the practice and that any personal travel of the Taxpayer or his family was not included. Accordingly, regarding these two

items of expenses which were disallowed by the assessor and the Commissioner, we are satisfied that they are deductible expenses regardless of the decision which we reach on the matters of principle in this appeal.

The Taxpayer went on to submit that the rationale for the management company was the limited liability enjoyed by the company in the non-professional areas of the practice as compared with the unlimited personal liability of himself as a professional dentist. When the Taxpayer gave evidence, he confirmed this point but we have some hesitation in accepting what he said. Whilst it may have been one of the reasons for his establishing the management company, we are not satisfied that it was either the only reason or indeed the dominant reason. It is significant to us that the Taxpayer never referred to the tax advantages which can arise from such arrangements. No evidence was given of the nature of the concern which the Taxpayer had for his unlimited liability in non-professional areas. It seems to us that his liability in such areas would be very modest. He employed one person and presumably rented office accommodation for his surgery which would be of modest size. In the course of giving evidence, the Taxpayer referred to his being mindful of Inland Revenue Guidelines when determining the fee to be paid by the practice to the management company. It appears to us that the significant taxation benefits which the Taxpayer sought to receive from the arrangement which he set up with the management company would have been of considerable interest to him in making the decision to use the management company and may well have been the dominant reason.

The Taxpayer submitted that there was a commercial rationale for the arrangement which he set up with his management company and said that it was neither artificial nor fictitious. He drew attention to the fact that the accounts of the management company had been accepted for taxation purposes by the Inland Revenue Department in relation to the tax affairs of the management company itself. He argued that it was not logical to say that the expenses were of a domestic or private nature or that the money had not been used for producing the profits of the practice. He submitted that it was wrong that the Commissioner should seek to tax the practice when it should have been taxing the management company and/or the Taxpayer as an employee of the management company. He said that the Commissioner was trying to circumvent the Inland Revenue Ordinance by seeking to disallow the expenses in the practice.

The Taxpayer went on to say that it was not material whether or not this was an attempt to obtain a tax deduction for expenses which were in the opinion of the Commissioner, domestic or private in nature, because that does not affect the validity of the arrangements. Section 6lA of the Inland Revenue Ordinance is not open to the Commissioner because its effective date was after this arrangement was instituted. He then drew attention to section 61of the Inland Revenue Ordinance and said that it can only apply if the arrangement was artificial or fictitious and in this case there was nothing artificial or fictitious in what had been arranged. He said that the management company was a separate entity and the Commissioner could not look behind the corporate veil.

With regard to the quantum of the management fee, the Taxpayer when giving evidence said that it was based on the 'quality and quantity of the services provided'. In fact 6 we have recorded what was stated by the Taxpayer but we do not accept that this was an accurate description of what was done. It appears to us that the management fee was determined by the Taxpayer in an arbitrary manner at the end of each year and had little or no commercial substance. It definitely had no relationship to the quantity of the services provided and appears to have been based on a combination of the expenses of the management company and the gross earnings of the practice. If the fee had been decided according to commercial principles, the fee would have been directly related to the cost of the services provided with a comparatively small element to cover the overhead and profit of the management company. The statement made by the Taxpayer that the fee related to the quality of the services provided is meaningless because if the quality was not acceptable, then the Taxpayer would have terminated the arrangement with the management company.

The representative for the Commissioner submitted that the management fee was not its entirety a management or services fee but was more akin in part to a gift from the practice to the management company. He said that the title given to a transaction or payment by the parties did not mean that that was the nature of the transaction or payment. He cited to us the following cases:

Re Euro Hotel (Belgravia) Ltd 51 TC 293
Jeffrey v Rolls Royce Ltd 40 TC 494
Henley v Murray 31 TC 351

He then drew our attention to sections 16(1) and 17(1)(b) of the Inland Revenue Ordinance which require expenses to be incurred 'in the production of profits' and 'for the purpose of producing such profits'. He referred us to the Court of Appeal decision in the case of Lo & Lo v CIR 2 HKTC 34 and CIR v Swire Pacific Limited HKTC 1145.

The representative then referred us to rule 2A(2) of the Inland Revenue Rules and submitted that there is a 'wholly and exclusively requirement' in the deductibility of expenses for profits tax purposes. He referred us to the following United Kingdom cases:

Bentleys, Stokes & Lowless v Beeson 33 TC 491
Strong and Company of Romsey Limited v Woodifield 5 TC 215
Ransom v Higgs 50 TC 1
MacKinlay v Arthur Young McClelland Moores & Co [1989] STC 898

He submitted that the relationship between the Taxpayer and his management company as employee and employer was not relevant and one must look at the relationship between the practice and the management company.

This case does not involve sections 6l and 6lA of the Inland Revenue Ordinance and this was confirmed by the representative for the Commissioner. The Taxpayer submitted that the reason for using the management company was to obtain the benefits of

limited liability so far as it was possible for a professional man to carry on a professional business. However as we have stated earlier in this decision, it is also quite clear that the beneficial tax consequences of using a self-owned management company was an important consideration. As the matter is not before us, we make no comment with regard to the applicability or otherwise of section 61 of the Ordinance. With regard to section 61A of the Ordinance, it was submitted by the Taxpayer that the provisions of this section only apply to transactions entered into or effected after 1986 and he pointed out that the arrangement between himself and his management company had been created long before the effective date of section 61A. Here again the question is not before us and it is neither necessary nor appropriate for us to make any finding.

Though the Taxpayer submitted that the arrangement between the practice and the management company was established for commercial reasons relating to limited liability, as we have said above we are satisfied that a significant, if not dominant, purpose of the arrangement was to minimize tax. What the Taxpayer has done is to attempt to circumvent the provisions of the Inland Revenue Ordinance so that he need to pay little tax on the profits which he makes in carrying on his profession as a dentist. He has sought to transfer by way of tax deductible expenses, his own private and personal expenses, which would otherwise have been paid out of 'after tax' income. Clearly, the items disallowed by the assessor such as club subscriptions and dues, motor car expenses and the interest expenses in purchasing residential accommodation are not legitimate business expenses of a dental practice. If what the Taxpayer has done in this case is permitted under the Inland Revenue Ordinance, then it opens the door to allow individuals who run their own businesses substantially to minimise their tax liability. Many potential home owners could obtain substantial tax benefits by arranging suitable bank borrowings. The opportunities for 'tax planning' would be endless. However a taxpayer is entitled to take advantage of whatever benefits he can obtain from the Inland Revenue Ordinance. It has long been held that there is no equity in taxation matters. One must look at the strict wording of the Inland Revenue Ordinance and if there are loopholes in the Ordinance, then it is not for this tribunal or the Courts of Law to remedy such matters but for the Legislative Council.

It is clear that the services provided by the management company as we have found in facts 4 and 5 above were provided to the practice for the production of the profits of the practice which are chargeable to tax. Accordingly, the fee paid to the management company for those services is prima facie deductible from the assessable profits of the practice under section 16(1) of the Inland Revenue Ordinance. Section 17(1)(a) of the Inland Revenue Ordinance states that domestic and private expenses are not permitted to be deducted. However, the services provided by the management company as set out in facts 4 and 5 above cannot be said to be of a private or domestic nature. Accordingly any fee paid in respect thereof must be capable of deduction under section 16(1) of the Inland Revenue Ordinance and cannot be disallowed under section 17(1)(a) as being domestic or private expenses.

Section 16(1) of the Inland Revenue Ordinance states that outgoings and expenses are deductible 'to the extent' to which they are incurred in the production of

taxable profits. The three words which we have quoted make it clear that each outgoing and expense must be looked at and analysed to find out to what extent it was incurred to produce the profit. What we must decide is what is the cost to the practice of the services provided. The Taxpayer invites us to accept that he was prepared to work as a dentist for many years without any net income for his services and allow a third party, namely, the management company, to take all of the benefit of his endeavours. He suggested during the hearing that it was reasonable that he should not make any profit when he first established his business as a dentist because he would be able to obtain greater rewards at a later date. With due respect, we are not prepared to accept such a proposition. If we accept the figures in fact 2 above at their face value, it would mean that the Taxpayer had been prepared to work as a full-time dental surgeon for a period of five years, making a loss in 1987 of $161,185 and a maximum profit in the year 1989 of $38,967. If he had not used the services of the management company with its extremely high overhead costs, the expenses of the practice would have been very substantially less than the amount of the management fee. Clearly the management fee was excessive for the services provided. However, if the fee was not artificial or fictitious and if the transaction did not come within section 61A of the Inland Revenue Ordinance, the question for us to consider is whether the assessor, the Commissioner and this Board have the power to challenge the quantum of the management fee. If the management fee was a lump sum and indivisible fee paid for the entirety of the services, then it would appear to us to be difficult on the wording of the Inland Revenue Ordinance to abrogate to ourselves the power to consider whether the quantum of an expense is reasonable or to reduce it by an arbitrary amount. On the other hand, if the management fee is capable of analysis and subdivision, then we are of the opinion that we have the power to allow the management fee 'to the extent' that it was incurred to produce the taxable profit and to disallow the balance.

The Taxpayer submitted that the management fee was based on the 'quality and quantity of the services rendered'. For the reasons stated earlier in this decision we do not accept this statement as being an accurate description of how the management fee was decided. The quality of the services provided by the management company under his sole management and control must be acceptable to the Taxpayer and to suggest that the fee he would pay to his corporate alter ego depended on his own skills and ability is not credible. It is clear to us as a matter of fact that the management fee was based on the expenses of the management company which were substantially different and very much larger than would be the bona fide cost of providing the services which the practice received. The management fee only reflected the quantity of the services in so far as the expenses of the management company bore a direct relationship to the services provided.

Having given the matter careful thought and having reviewed all of the evidence before us, we find as a matter of fact that the management fee paid by the Taxpayer to the management company was made up of a number of component parts which though not set with precision were intended to approximate the expenses which the management company had and not the cost of the services which it provided to the practice.

Having so decided as a matter of fact the nature of the management fee, it is clear to us that the whole of the management fee was not incurred by the Taxpayer on behalf of the practice in the production of profits in respect of which the Taxpayer is chargeable to profits tax. A substantial part of the management fee was nothing more than an overpayment or gift from the practice to the management company to enable the management company to meet its expenses. Many of those expenses had no reference to the business of the practice, or the profits earned by the practice. Section 16(1) makes it quite clear that the management fee is deductible only to the extent to which it is incurred in the production of taxable profits. The Deputy Commissioner in his determination has disallowed part of the management fee in the manner that we have set out in fact 11 above, though for different reasons to those we have set out. In the course of the hearing we have been satisfied that the whole of the travelling expenses, part of which the Commissioner had disallowed, and the education expenses, all of which the Commissioner had disallowed, were incurred in earning the taxable profits of the practice. However with regard to the other expenses disallowed by the Deputy Commissioner in his determination, we are of the opinion that though they formed part of the management fee paid by the practice, they were not incurred for the purpose of earning the profits of the practice.

We have reached a decision the effect of which is substantially the same as that of the Deputy Commissioner but we have done so for very different reasons. We were asked by the representative for the Commissioner in the course of the hearing to comment on one particular matter in this regard.

Following the reasoning of the Deputy Commissioner in his determination, the representative for the Commissioner submitted that the test to be applied in deciding whether or not expenses can be deducted for profits tax purposes was whether or not such expenses were wholly and exclusively incurred in earning the profit. In support of his argument he referred the Board to or tabled before the Board the following cases:

Bentleys, Stokes & Lowless v Beeson 33 TC 491
Strong and Company of Romsey Limited v Woodifield 5 TC 215
Ransom v Higgs 50 TC 1
MacKinlay v Arthur Young McChelland Moores & Co [1989] STC 898
Copeman v William Flood & Sons Ltd 24 TC 53

He submitted that Inland Revenue Rule 2A applied and drew the attention of the Board to the fact that the Privy Council in a recent case relating to the Hang Seng Bank Ltd had held that expenses should be apportioned under rule 2A(1). It is not entirely clear what was the relevance of referring the Board to the Hang Seng Bank decision of the Privy Council other than to suggest that in some ways the Privy Council had given its blessing to rule 2A(2). The representative said rule 2A(2) was his authority for submitting that the United Kingdom test of 'wholly and exclusively' applies to profits tax assessments in Hong Kong and that it was necessary to apportion expenses between that part of an expense which was wholly and exclusively incurred to earn a profit and to disregard that part which was not.

In this case and in another recent appeal D69/90, IRBRD, vol 5, 485, the Commissioner has sought to introduce into our profits tax law the requirement that expenses must be 'wholly and exclusively' incurred. In D69/90 at page 487 the Board of Review made the following statement:

> ' The representative for the Commissioner submitted that the medical expenses were not deductible and based his submission on a number of United Kingdom cases, Australian cases and a United Kingdom textbook. With due respect to the Commissioner's representative, we find little help from most of the cases which he cited to us as they were decided on different laws which have significantly different wording to those of our own Inland Revenue Ordinance. Much of what the representative said revolved round words such as "wholly and exclusively" which do not form part of our profits tax law.'

In that appeal the Board was not referred to Inland Revenue Rule 2A(2) as the authority for 'wholly and exclusively' being the Hong Kong test.

In many cases relating to salaries tax, representatives for the Commissioner have submitted, when arguing that expenses are to be disallowed, that there is a fundamental distinction between salaries tax and profits tax in Hong Kong. Many representatives have unequivocably and rightly stated that the test for expenses in salaries tax matters is whether or not the expense is wholly, exclusively and necessarily incurred in earning the taxable emoluments. These are the words contained in section 12(1)(a) of the Inland Revenue Ordinance which applies to salaries tax. It has often been pointed out to previous Boards that the words 'wholly, exclusively, and necessarily' are notoriously restrictive and that each of the three words must be given a separate and distinct meaning. This has been contrasted with the position in relation to profits tax where such stringent words are not used.

A number of cases have come before different Boards of Review in which it has been argued that an individual is carrying on business and is not an employee. The very essence of these cases is the difference in wording between sections 12(1)(a) and 16(1) of the Inland Revenue Ordinance. It has always been recognised that section 12(1)(a) is much more restrictive. However, if we now import the words 'wholly and exclusively' into section 16(1) then the only difference would be the word 'necessarily'. Few cases in the past relating to salaries tax have turned on whether or not an expense was necessary. In our opinion there is a fundamental difference between profits tax and salaries tax. If the words 'wholly and exclusively' are intended to be part of our profits tax law, then they should be included in section 16(1) of the Inland Revenue Ordinance.

We have taken due note of the representative's submission that the words 'wholly and exclusively' appear in Inland Revenue Rule 2A(2). It is a fundamental rule of constitutional law that an Act of Parliament or an Ordinance of the Legislative Council cannot be amended by subsidiary legislation. The Inland Revenue Rules can amplify or add to the Inland Revenue Ordinance within the scope of section 85 of the Inland Revenue

Ordinance. It is not for us to comment on whether or not the rule to which the Commissioner's representative referred us is within the scope of section 85 of the Inland Revenue Ordinance but there must be some doubts as to whether or not the provisions of rule 2A(2) go beyond the meaning and ambit of section 85. However that is not relevant to the point before us which is simple and easy to answer. Section 12(1)(a) of the Inland Revenue Ordinance refers to expenses being wholly, exclusively and necessarily incurred. Those words do not appear in section 16(1) nor anywhere else in section 16 and they do not appear anywhere in section 17 which is the exclusive section. If it was the intention, which we doubt, of the Board of Inland Revenue to change the provisions of sections 16 and 17 of the Inland Revenue Ordinance by including the words 'wholly and exclusively', then it would be ultra vires their powers and most certainly outside the scope of section 85 of the Inland Revenue Ordinance. As it is clear to us that the expenses which we have disallowed were not incurred for the purpose of producing the profits which are being assessed, it is irrelevant further to consider the meaning of rule 2A(2).

For the reasons which we have set out above, we find in favour of the Taxpayer but only to the extent of the overseas travelling expenses and the education expenses which had been disallowed by the Commissioner. With regard to the other expenses which are the subject matter of this appeal, we confirm the assessments against which the Taxpayer has appealed. We direct that the assessments be remitted back to the Commissioner to be reduced by the amount of the overseas travelling expenses and education expenses which had been previously disallowed.