INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D62/01

Profits tax – accounting adjustment – whether error – managing fee – whether having commercial basis – section 70A of the Inland Revenue Ordinance (' IRO').

Panel: Anna Chow Suk Han (chairman), Joseph Cheung Wang Ngai and Michael Neale Somerville.

Date of hearing: 8 November 2000.
Date of decision: 3 August 2001.

Mr B and his wife were the only shareholders of the taxpayer company which provided managing service to other companies in return for managing fees. Mr B was also a partner of a solicitor firm (the firm). The taxpayer company was engaged by the firm to provide managing service to them for management fees.

The taxpayer lodged a claim under section 70A of the IRO for revision of the profits tax assessments on the ground that the management fees paid to them by the firm, following accounting adjustments, were reverted to the firm as Mr B' s drawings. Thus there were errors in the tax returns. Besides, the transactions between the firm and the taxpayer had no commercial basis and thus being not taxable.

Held:

The Board found that the management fee income received by the taxpayer was trading profits and disagreed that the transactions between the firm and the taxpayer had no commercial basis.

Obiter:

Where a taxpayer has deliberately and conscientiously made a decision to submit a certain item for assessment in its return, but subsequently changes his mind, that cannot be a correctable error within the meaning of section 70A of the IRO. The Board observed that had the taxpayer pursued that the adjustment is an error, they would have failed in this regard (Chinachem Investment Co Ltd v CIR; Extramoney Limited v CIR and D14/88 considered).

Appeal dismissed.

Cases referred to:

D64/87, IRBRD, vol 3, 60
D110/98, IRBRD, vol 13, 553
D19/99, IRBRD, vol 14, 209
Chinachem Investment Co Ltd v CIR 2 HKTC 261
Extramoney Limited v CIR 4 HKTC 394
D14/88, IRBRD, vol 3, 206

Cheung Lai Chun for the Commissioner of Inland Revenue.
Tai Kiun Ngee Dominic of Messrs Dominic K N Tai & Co, Certified Public Accountants, for the taxpayer.

Decision:

The appeal

1. Company A (' the Taxpayer') has objected to the profits tax assessment for the year of assessment 1996/97 and the assessor' s notice of refusal to correct the profits tax assessment for the year of assessment 1995/96 under section 70A of the IRO. The Taxpayer claims that part of the management fee income it received during the years of assessment 1995/96 and 1996/97 should not be assessed to tax.

The facts not disputed

2. The Taxpayer was incorporated as a private company in Hong Kong on 4 November 1988. At all relevant times, Mr B and his wife, Madam C, were the only shareholders and directors of the Taxpayer.

3. Since 1 August 1994, Mr B has also been a partner of a solicitor firm practicing under the name of Company D (' the Firm').

4. On 1 July 1995, the Taxpayer and the Firm entered into a service agreement whereby the Firm engaged the Taxpayer as its manager and leased from the Taxpayer certain office

equipments and vehicles at a monthly consideration of $300,000 for three years retrospectively from 1 August 1994.

5. The Firm provided in its 1995/96 and 1996/97 profits tax computations and accounts, inter alia, the following particulars:

Year ended	**30-6-1995**	**30-6-1996**
	$	$
Management fee paid to the Taxpayer	1,025,000	3,622,617
Assessable profits	1,125,598	2,608,139

6. In response to the assessor' s enquiries, the Firm, through its representatives, provided the following further particulars and revised profits tax computations:

(a) A breakdown of the management fee paid to the Taxpayer from October 1994 to June 1997:

Period	**Amount**
	$
October 1994 to March 1995	625,000
April 1995 to June 1995	400,000
July 1995 to March 1996	2,409,914
April 1996 to June 1996	1,212,703
July 1996 to March 1997	3,139,268
April 1997 to June 1997	1,067,718

(b) A 1995/96 proposed revised profits tax computation of the Firm:

	$
Assessable profits per return	1,125,598
Add: Management fee paid to the Taxpayer from April 1995 to June 1995	400,000
Revised assessable profits	1,525,598

(c) ' [the Firm] has agreed with [the Taxpayer] that the management fee paid to them from April 1995 should be reverted and accounted as [Mr B' s] drawings…'.

(d) ' Regarding the balance of management fee paid for the year ended 30 June 1995, the relevant fee was paid before the enactment of section 9A of [the IRO] which was effective on 18 August 1995. Accordingly, there will be no effect on such fee paid. As stated in paragraph 29 of the Departmental Interpretation and

Practice Notes (' DIPN') No 24, the assessment would be final and conclusive in terms of section 70 of the IRO and would not be re-opened for the purpose of adjusting a management fee claim to reflect the Practice Note.'

(e) A 1996/97 proposed revised profits tax computation of the Firm with the following adjustments under DIPN No 24:

	$	$
Assessable profits per return		2,608,139
Add: Management fee paid to the Taxpayer	3,622,617	
Other items	1,276,890	4,899,507
		7,507,646
Less: Cost of qualifying services plus a 12.5% mark-up		646,387
Revised assessable profits		6,861,259

Note

The cost of qualifying services plus mark-up was computed as follows:

	$
Depreciation of relevant fixed assets	354,601
Motor car expenses	4,465
Staff salaries	215,500
Cost of qualifying services	574,566
Add: Mark-up of 12.5%	71,821
Cost of qualifying services plus mark-up	646,387

7. The Firm' s proposed management fee adjustments in paragraphs (6)(b) and (e) were accepted by the assessor and the Firm' s assessable profits were computed accordingly.

8. In its profits tax returns for the years of assessment 1995/96 and 1996/97, the Taxpayer described the nature of its business as ' management consultancy and property investment' . In its accounts and profits tax computations, the Taxpayer gave, inter alia, the following particulars:

Year ended	**31-3-1996**	**31-3-1997**
	$	$
Consultancy and management fee income	2,809,915	3,935,339

Assessable profits	908,972	2,585,412

9. On 16 December 1996, the assessor raised on the Taxpayer the following profits tax assessment for the year of assessment 1995/96.

	$
Assessable profits per return	908,972
Tax payable	149,980

10. The Taxpayer did not object to the profits tax assessment for the year of assessment 1995/96.

11. On 26 November 1997, the assessor raised on the Taxpayer the following profits tax assessment for the year of assessment 1996/97:

	$
Assessable profits per return	2,585,413
Tax payable	426,592

12. By a letter dated 15 December 1997, Messrs Dominic K N Tai & Company (' the Representatives'), on behalf of the Taxpayer, objected against the profits tax assessment for the year of assessment 1996/97 of the Taxpayer on the ground that the assessment was excessive. The Representatives claimed that the 1996/97 profits tax computation submitted was not correct because adjustments in paragraph (6)(e) in respect of the Firm had not been taken into account.

13. By another letter also dated 15 December 1997, the Representatives, on behalf of the Taxpayer, lodged a claim under section 70A of the IRO for revision of the profits tax assessment for the year of assessment 1995/96 of the Taxpayer on the ground that there were errors in the 1995/96 profits tax computation submitted because adjustments in paragraph (6)(b) in respect of the Firm had not been taken into account.

14. To support the Taxpayer' s objection and section 70A claim, the Representatives submitted 1995/96 and 1996/97 revised profits tax computations which showed no assessable profit. The computations gave the following revised particulars:

	1995/96	**1996/97**
	$	$
Profits per computation previously submitted	908,972	2,585,412

Less: Management fee adjustment	1,868,185	3,230,155
Adjusted loss	(959,213)	(644,742)

Note

The mangement fee adjustments were computed as follows:

	1995/96	**1996/97**
	$	$
Cost element		
Administrative staff salaries	215,500	192,500
Depreciation allowances	617,128	347,976
Motor running expenses	4,465	86,354
	837,093	626,830
Add: Mark-up of 12.5%	104,637	78,354
Allowable management fee	941,730	705,184
Less: Management fee per accounts	2,809,915	3,935,339
Management fee adjustment	(1,868,185)	(3,230,155)

15. In response to the assessor' s enquiries, the Representatives on behalf of the Taxpayer provided the following particulars and documents:

(a) A breakdown of the consultancy and management fee income for the years ended 31 March 1996 and 31 March 1997.

(b) The entire amounts of the management fees were received from the Firm.

(c) The management fees were paid into the Taxpayer' s bank account at Bank E.

(d) The Taxpayer had not refunded any part of the management fees to the Firm.

16. The assessor was not satisfied that the tax charged for the year of assessment 1995/96 was excessive by reason of an error or omission. By a notice dated 1 April 1999, the assessor asked the Taxpayer to consider withdrawing its objection to the profits tax assessment for the year of assessment 1996/97 and also notified the Taxpayer of his refusal to correct the assessment for the year of assessment 1995/96 under section 70A of the IRO.

17. By a letter dated 29 April 1999, the Representatives informed the assessor that the Taxpayer was not prepared to withdraw its objection against the profits tax assessment for the year of assessment 1996/97. The Representatives also objected on behalf of the Taxpayer against the

assessor's notice of refusal to correct the profits tax assessment for the year of assessment 1995/96 under section 70A and advanced the following contentions:

> '…The transaction in question for the above years of assessment was the provision of infrastructure and administrative support to [the Firm]. The transaction resulted in an income to the provider and an expense to the recipient.
>
> Your department's practice is to disallow a portion of the expenses by taking the view that the payments from the transactions were commercially unrealistic, under common control and therefore were not wholly incurred in the production of chargeable profits…
>
> The transaction in question is analogous to the flip side of the same coin… If a transaction has no business reality, then it should be just that – it has no business reality to both the provider and the recipient…
>
> …The error made was that our clients took a consistent and symmetrical view regarding the treatment of the management fees (because they related to the same events) in both entities…
>
> …Our clients feel that they are severely aggrieved and their business would suffer if as a result were taxed twice on the same transaction.'.

Reasons for the Commissioner's determination

18. In the determination of 18 May 2000, the Commissioner gave the following reasons for his determination:

(a) Mr B controlled and participated in the management of both the Taxpayer and the Firm. During the years of assessment in question, the Taxpayer allegedly provided the Firm with management services and facilities in return for a fee. However, the evidence showed that the management fees were not determined on an arm's length basis. The Firm subsequently agreed with the Revenue that the management fees should be restricted and were not fully deductible. The Firm then re-computed the management fees by the cost-plus method and the management fee adjustments were accordingly made by the Firm.

(b) When the Firm made its management fee adjustments, the Taxpayer did not ask for a re-computation of its assessable profits. The Taxpayer did not deny the receipts of the management fees charged against the Firm. Those fees were recorded as parts of its turnover in the Taxpayer's accounts. Thus, the accounts did not contain any error or omission. The Taxpayer could have overcharged the Firm and the Firm could have overpaid the Taxpayer but this fact alone

would not turn the management fees into non-taxable income of the Taxpayer. The chargeability of the management fees in the Taxpayer's accounts had nothing to do with its deductibility in the Firm's accounts. The management fees received remained the income of the Taxpayer from the carrying on of its management consultancy business in Hong Kong and were therefore fully taxable.

(c) The Taxpayer sought to re-open the profits tax assessment for the year of assessment 1995/96 by invoking section 70A of the IRO by reason of an error or omission in the Taxpayer's accounts. The Representatives claimed that the error was that the Taxpayer and the Firm did not take 'a consistent and symmetrical view regarding the treatment of the management fees'. This alleged error was a matter of hindsight and was no more than a change of opinion. Hence, as far as the assessment for the year of assessment 1995/96 was concerned, there was no error or omission within the meaning of section 70A.

The Taxpayer's grounds of appeal

19. The Taxpayer disagreed with the Commissioner on his reasons for the determination. The Representatives filed a notice of appeal on 15 June 2000 ('the Notice of Appeal'), giving the following grounds or appeal:

(a) the Taxpayer's profits tax returns for the years of assessment 1995/96 and 1996/97 contained errors and omissions because they were not prepared in accordance with the practices which prevailed at the time, that is, to apply the management fee adjustment acceptable to the Inland Revenue Department ('IRD') as per the DIPN No 24 which was published in August 1995; and

(b) the income in question was non-commercial in nature and should be excluded as taxable income under section 14 of the IRO.

20. The Representatives also raised the following arguments in the Notice of Appeal:

Errors and omission

(a) An error or omission could only be discovered after the event, with the benefit of hindsight.

(b) The error was not a change of opinion since the treatment of management fee income in the tax computation was erroneous right at the start because it did not take into account the non-commercial portion of the income as not assessable to profits tax. The error or omission was the failure to apply the DIPN No 24

calculation in relation to Type II Service Company management fees. Due to this omission to exclude the non-commercial part of the fee income, the income was treated as assessable income in the tax computation.

(c) As to the Commissioner's view that there was no error or omission because the management fees were actually received and recognized as income in the Taxpayer's accounts, the inclusion of the management fees in the accounts and tax computation was precisely the error or omission that the objections related. As a result of the inclusion, the income and hence assessable profits were overstated.

(d) DIPN No 24 with regard to Type II Service Company management fees were published in August 1995 and therefore applied to the Taxpayer's tax returns for both years of assessment 1995/96 and 1996/97, which were submitted on 15 November 1996 and 15 November 1997 respectively. Although DIPN No 24's emphasis was on the deductibility of management fee to a firm where the firm and the service company were under common control, it was the prevailing practice that the cost plus principle was used in accounting for the taxability of the management fee to the service company. As the tax computations for the said returns were not prepared in accordance with practices which prevailed at the time, that is, post DIPN No 24, correction should be made to the returns.

(e) As to the Commissioner's conclusion that the management fees recorded in the accounts were correct and the accounts contained no error because (1) the Taxpayer did no ask for a re-computation of its profits tax when the Firm made the management fee adjustments and (2) the Taxpayer did not claim that it did not receive the management fee, on (1) the Taxpayer did ask for re-computation of its profits tax assessments for the years of assessment 1995/96 and 1996/97 on 18 December 1997 which was respectively before and shortly after the Firm made the management fee adjustments for the respective years and on (2) the question was not whether the Taxpayer did receive the management fees, but was whether all or only parts of the management fees should be assessable to profits tax.

Commercial reality

(f) The expression 'trade or business' in section 14 of the IRO connotes transactions with a commercial flavour. Accordingly, when a taxpayer's transactions had no apparent commercial justification, he was not engaged in a trading venture as his activity had no commercial basis and the income therefrom should be treated as non-assessable (D64/87, IRBRD, vol 3, 60). The

management fee income had no commercial basis and should be treated as non-assessable income.

Overcharging and parties to the same transaction

(g) As to the Commission's conclusion that mere overcharging the Firm would not turn the income into non-taxable, this conclusion would be right if the Firm and the Taxpayer proposed to do nothing about the overcharging but presently the Firm had agreed with the Taxpayer that the management fees should be reverted and accounted for as the drawings of Mr B, a partner of the Firm, which meant that the Firm had a refund.

(h) On the facts that the fees were paid into the Taxpayer's bank account and the Taxpayer had not refunded any part of the fees to the Firm, there was no necessity for the management fees to be physically transferred back to the Firm because the Firm had already treated the management fees paid as a partner's drawings in the Firm's account with the result that the director/shareholder of the Taxpayer owed the Firm the adjusted amount and accordingly, the Taxpayer could retain the money and an accountancy entry would be made to the Taxpayer's latest set of accounts to reflect the fact that the Taxpayer now owed the director the same amount.

No intention to defraud

(i) The Taxpayer had no intention to defraud the IRD as service company arrangement was an accepted arrangement for tax purposes before the issuance of DIPN No 24. As soon as the 'error and omission' were discovered after the submission of the tax returns, the Taxpayer immediately proposed the adjusted tax computations.

The Taxpayer's submission

21. At the hearing, the Taxpayer was represented by Mr Tai Kiun-ngee, Dominic of the Representatives. Mr B, a director of the Taxpayer was present but did not give evidence on behalf of the Taxpayer. No witness was called. The statement of facts prepared by the Revenue was not disputed by the Taxpayer.

22. Mr Tai on behalf of the Taxpayer made oral submissions to the Board. He submitted that the appeal was against the Commissioner's refusal to correct the assessment for the year of assessment 1995/96 pursuant to section 70A of the IRO and the assessment for the year of assessment 1996/97.

23. He submitted that the first issue of this appeal was whether there was an error in the Taxpayer' s tax returns for both years of assessment and if there was error, whether it was an error within section 70A of the IRO for the purpose of the assessment for the year of assessment 1995/96.

24. It was submitted that there was an error in the Taxpayer' s tax returns for both years of assessment 1995/96 and 1996/97. The error was in the calculation of the amount of the assessable income. The error was the omission to exclude the non-taxable portion of the management fee income in the tax computation. The error arose because the Taxpayer and the Firm engaged different tax representatives. Between them they did not review and reconcile the management fees in question. Furthermore the accounting periods of the Taxpayer and the Firm were not coterminous. By using spread sheets, the Representatives followed the previous year' s tax computation and did not exclude the non-taxable part of the profits from the tax computation. The errors for both years of assessment were finally discovered in December 1997.

25. The Representatives objected to the Commissioner' s determination that there was no error in the Taxpayer' s accounts because:

(a) when the Firm made its management fee adjustments, the Taxpayer did not ask for re-computation of its assessable profits;

(b) the Taxpayer did not deny the receipts of the management fees in question and the amount was correctly recorded in the accounts; and

(c) the management fees were recorded as income in the Taxpayer' s accounts.

26. Rebutting the Commissioner' s reasons for the determination that there was no error, the Representatives asserted that:

(a) re-computation of the assessable profits for both years of assessment were submitted on 18 December 1997; and

(b) taxable profits were different from accounting profits. The Taxpayer' s accounts were correct but it did not follow that all the accounting profits were fully taxable. The error was in the tax computation in that the non-taxable portion of the income had not been excluded.

27. The Representatives submitted that the stated error was an error within the ambit of section 70A of the IRO for the purpose of the assessment for the year of assessment 1995/96. He said that the inclusion of the management fee in the tax returns as fully taxable was not a deliberate act but was an error, as no reasonable taxpayer would deliberately include an amount as fully taxable when it was not and in particular when (1) section 14 of the IRO provided that only trading

profits derived from a business would be chargeable to tax and (2) DIPN No 24 which was issued prior to the Taxpayer's submission of its tax returns, stated that management fee from a firm to a service company would be treated as fully taxable. He disputed that the claim of an error was a matter of hindsight and was a mere change of opinion as suggested by the Commissioner. He asserted that it was a matter of fact and not of opinion that the Taxpayer's management fee income was not trading income and thus not taxable.

28. The Representatives submitted that the second issue was the question of whether the management fee income was trading income chargeable to profits tax under section14 of the IRO.

29. The Representatives stated that in determining the chargeability of the management fee income, one had to consider whether or not the income derived from the carrying on of a trade or business within the meaning of section 14 of the IRO. He said that since the Commissioner agreed and regarded the transactions between the Taxpayer and the Firm as lacking commercial purpose, it must follow that the income derived therefrom could not be regarded as trading profits and was therefore not taxable. He asserted that the Taxpayer could not be regarded as being engaged in a trade of services as the general characteristics or badges of trade were lacking in its dealings. He added that the income could not be regarded as trading income but was more like a gift in nature.

30. The Representatives objected to the Commissioner's stance that the Firm and the Taxpayer were two separate entities and the deductibility of the management fees to the Firm had nothing to do with its chargeability to profits tax to the Taxpayer. He asserted that the Commissioner's treatment of the Firm and the Taxpayer as two separate entities should have no effect on the true nature and substance of the transactions between them. He argued that the same transactions could not be non-commercial in nature to the Firm on the one hand and commercial in nature to the Taxpayer on the other. He used the analogy that ' a gift by a donor remains a gift to the recipient' .

31. The Representatives concluded that the transactions between the Firm and the Taxpayer were non-trading in nature and thus the income therefrom should not be assessable to profits tax under section 14 of the IRO.

32. The Representatives also presented this Board with a written summary of the submission made.

The Respondent's submission

33. The Respondent presented this Board with a detailed written submission which is summarized as below.

The relevance of DIPN No 24

34. DIPN No 24 is not applicable to the Taxpayer' s case for the following reasons:

(a) The whole tenor of DIPN No 24 is to address the question of whether or not the management fees paid or payable to a service company can be allowed as a deduction in the payer' s file. The practice note does not deal with the position of the recipient. The chargeability of the management fee has nothing to do with its deductibility.

(b) The formula set out in DIPN No 24 is for determining the maximum allowable amount of the management fee paid or payable by an unincorporated business to a service company. It has no application to the recipient.

(c) The payer, that is, the Firm, and the recipient, that is, the Taxpayer, while connected in some ways, are separate and distinct persons for tax purposes. The tax position of the Firm does not affect that of the Taxpayer.

(d) Contrary to the Representatives' claim, it has never been a prevailing accounting or tax practice to make reciprocal adjustments for the management fee income of a service company based on the formula set out in DIPN No 24.

(e) DIPN No 24 is not part of the law. As pointed out by the Board in D110/98, IRBRD, vol 13, 553 and D19/99, IRBRD, vol 14, 209, what has to be applied in determining the Taxpayer' s tax liabilities is the law, that is, the IRO, and not DIPN No 24.

The applicable law – section 14

35. Under section 14 of the IRO, three conditions must be satisfied before a liability to profits tax could arise:

(a) a person carries on a trade, profession or business in Hong Kong;

(b) the person derives profits from the trade, profession, or business, other than profits arising from the sale of capital assets; and

(c) those profits arise in or are derived from Hong Kong.

36. The question of whether or not there was a trade or business, was a question of fact and the test was an objective one. In the present case, it is clear from the evidence that the Taxpayer was carrying on a business in Hong Kong during the years in question:

(a) The Taxpayer declared in its profits tax returns for the years of assessment 1995/96 and 1996/97 that its principal business activity was ' management consultancy and property investment' .

(b) The directors, in their reports attached to the profits tax returns for the years of assessment 1995/96 and 1996/97, described the principal activities of the Taxpayer as ' the provision of management consulting services and property investment for the generation of rental income' .

(c) The provision of management consultancy services in return for pecuniary reward and property letting are operations of a commercial character.

The nature of the disputed income

37. The disputed income was management fee income the Taxpayer derived from its management consultancy business carried on in Hong Kong:

(a) The fees received by the Taxpayer had its source from the service agreement dated 1 July 1995 entered into between the Firm and the Taxpayer.

(b) The service agreement was a commercial agreement. It exists and is legally enforceable.

(c) The Taxpayer was paid the fees for its provision to the Firm the various services and facilities specified under schedules II and III of the service agreement.

38. On the contrary, there is no evidence which shows that the management fees were in fact drawings made by Mr B from the Firm:

(a) The fees were charged in the Firm' s 1995/96 and 1996/97 accounts as ' management fee paid to the Taxpayer' and not as partner' s drawings.

(b) The payments were made by the Firm to the Taxpayer and not to Mr B personally.

(c) There is no evidence that the Taxpayer had any obligation to pay Mr B the fees it received from the Firm. In fact, the Taxpayer did not pay over the money to Mr B.

39. Although the management fees were not determined on an arm' s length basis and wee commercially unrealistic in amounts, it does not follow that the fees are non-commercial or non-trading in nature.

40. It is not open to the Taxpayer to manipulate its accounts and exclude part of its income as not its income or as non-taxable as it wishes. A subsequent adjustment, even if made, cannot change the true nature of the fees.

Whether the disputed income is taxable

41. The disputed income should be brought into the computation for profits tax in the Taxpayer' s accounts because the Taxpayer had duly received and placed the relevant amounts in its bank account and the same were recognized as part of the Taxpayer' s turnover in its accounts and had never been refunded by the Taxpayer to the Firm.

Whether part of the fees can be excluded

42. In general, assessable profits are profits arrived at under generally accepted accounting principles, as adjusted to comply with the specific requirements of the IRO.

43. The IRO deals little with the receipt side of the account except to include certain receipts as deemed business receipts and to exclude certain items or receipts for tax purposes. The management fees received by the Taxpayer in the present case did not come within any of those exclusions provided under the IRO so far as the years of assessment 1995/96 and 1996/97 are concerned.

44. There is also no specific provision in the IRO for apportioning the management fee income under the kind of circumstances the Taxpayer was in.

Section 70A claim

45. As to the Taxpayer' s claim of an omission or error within the provision of section 70A, the inclusion of the management fee income as the Taxpayer' s business receipts was a deliberate act by the person who prepared the accounts and the Representatives who audited them and gave an unqualified report. The Taxpayer had failed to establish that there was an error in the accounting treatment of the management fee income.

46. For section 70A to apply so as to enable past assessments to be re-opened, there must have been an ' error or omission' in a return or statement submitted in respect thereof, or an ' arithmetical error or omission' in the calculation of the amount of the profits assessed or in the amount of the tax charged. In the present appeal, the Board need only concern itself with the first limb of section 70A, that is, whether there has been as ' error or omission' in the 1995/96 return and accompanying accounts. It was submitted that the Taxpayer has not discharged its onus to show that there was an error or omission in the return or statement submitted.

47. By virtue of section 51(5) of the IRO, any person signing the profits tax return ' shall be deemed to be cognizant of all matters therein' . Since the Taxpayer' s 1995/96 return was signed by Madam C, one of its directors, she was deemed to be aware of the inclusion of the income in question in the profits and loss accounts and in turn, the income was assessable profits. Thus, on the evidence the Taxpayer had accepted that at the material times the management fee income was income from its business and was assessable to tax. By bringing this appeal, the Taxpayer was taking a different view of the nature of the management fee income, for tax purposes. It therefore followed that the alleged ' error of including it in the tax computation' was no more than a mere change of opinion. In the absence of evidence to rebut the inference that the director knew the facts which gave rise to the disputed income being stated and returned as assessable, the Taxpayer had failed to discharge the onus to show that there was an ' error or omission' within the ambit of section 70A.

48. By section 68(4) of the IRO, the onus of proof is placed on the Taxpayer to establish that the assessments appealed against are excessive or incorrect. Accordingly, the Taxpayer has failed to discharge such onus, and the appeal should be dismissed.

The relevant statutory provisions

49. Section 14(1) of the IRO provides that:

> *' Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from a trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.'*

50. Section 2 of the IRO contains definitions for the following terms which appear in section 14(1):

(a) ' assessable profits' means the profits in respect of which a person is chargeable to tax for the basis period for any year of assessment, calculated in accordance with the provisions of Part IV;

(b) ' business' includes agricultural undertaking, poultry and pig rearing and the letting or sub-letting by any corporation to any person of any premises or portion thereof, and the sub-letting by any other person of any premises or portion of any premises held by him under a lease or tenancy other than from the Government;

(c) ' person' includes a corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons;

(d) ' profits arising in or derived from Hong Kong' for the purposes of Part IV shall, without in any way limiting the meaning of the term, include all profits from business transacted in Hong Kong, whether directly or through an agent;

(e) ' trade' includes every trade and manufacture, and every adventure and concern in the nature of trade.

51. Section 51(5) of the IRO provides that:

' A return, statement, or form purporting to be furnished under this Ordinance by or on behalf of any person shall for all purposes be deemed to have been furnished by that person or by his authority, as the case may be, unless the contrary is proved, and any person signing any such return, statement, or form shall be deemed to be cognizant of all matters therein.'

52. Section 68(4) provides that:

' The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.'

53. Section 70 provides that:

' Where no valid objection or appeal has been lodged within the time limited by this Part against an assessment as regards the amount of the assessable income or profits or net assessable value assessed thereby, or where an appeal against an assessment has been withdrawn under section 68(2A) or dismissed under subsection (2B) of that section, or where the amount of the assessable income or profits or net assessable value has been agreed to under section 64(3), or where the amount of such assessable income or profits or net assessable value has been determined on objection or appeal, the assessment as made or agreed to or determined on objection or appeal, as the case may be, shall be final and conclusive for all purposes of this Ordinance as regards the amount of such assessable income or profits or net assessable value…'

54. Section 70A provide that:

'(1) Notwithstanding the provisions of section 70, if, upon application made within 6 years after the end of a year of assessment or within 6 months after the date on which the relative notice of assessment was served,

whichever is the later, it is established to the satisfaction of an assessor that the tax charged for that year of assessment is excessive by reason of an error or omission in any return or statement submitted in respect thereof, or by reason of any arithmetical error or omission in the calculation of the amount of the net assessable value (within the meaning of section 5(1A)), assessable income or profits assessed or in the amount of the tax charged, the assessor shall correct such assessment:

Provided that under this section no correction shall be made to any assessment in respect of an error or omission in any return or statement submitted in respect thereof as to the basis on which the liability to tax ought to have been computed where the return or statement was in fact made on the basis of or in accordance with the practice generally prevailing at the time when the return or statement was made.

(2) Where an assessor refuses to correct an assessment in accordance with an application under this section he shall give notice thereof in writing to the person who made such application and such person shall thereupon have the same rights of objection and appeal under this Part as if such notice of refusal were a notice of assessment.'

Our findings

55. The Respondent had referred us to the following authorities:

(a) Chinachem Investment Co Ltd v CIR 2 HKTC 261
(b) Extramoney Limited v CIR 4 HKTC 394
(c) D14/88, IRBRD, vol 3, 206
(d) D110/98, IRBRD, vol 13, 553
(e) D19/99, IRBRD, vol 14, 209

56. We have drawn the following legal principles from those authorities.

57. DIPN No 24 cannot alter the law and it is the IRO, and not the practice note, that the Board has to apply (see D110/98).

58. DIPN No 24 did not change the law and it merely set out the Department's legal weaponry to attack service company arrangements (see D19/99).

59. Macdougell J said in his decision in Chinachem Investment Co Ltd v CIR HKTC 261 at page 282:

> *'If a tax payer wishes to challenge the accuracy of its own audited statements [sic] and tax declarations made by a director it is not sufficient merely to say that either a mistake was made or that the accounts were kept in a particular form which was incorrect "for convenience". Evidence to substantiate the mistake must be given in the strongest terms.'*

60. In Extramoney Limited v CIR 4 HKTC 394, it was held that where a taxpayer has deliberately and conscientiously made a decision to submit a certain item for assessment in its tax return, but subsequently changes his or her mind, that cannot be a correctable ' error' within the meaning of section 70A of the IRO.

61. In Board of Review decision D14/88, it was held, inter alia, the following:

(a) Accounts are not definitive, but they are important because they indicate what view was taken by the relevant parties at the relevant time.

(b) Although it was open to a taxpayer to claim that it had offered the interest to tax in error, the onus of proof upon it was a heavy one.

(c) Where accounts have been properly maintained according to sound commercial accounting principles, tax should be assessed on the profits shown in such accounts.

(d) It was permissible to rewrite accounts where they had been prepared otherwise than in accordance with sound commercial accounting principles. However, it was not permissible to rewrite accounts which had been properly drawn up at the relevant time merely because, within the benefit of hindsight, it was possible to say that particular items had turned out to be inaccurate, or should have been the subject of a provision, or should have been included in a suspense account. Where items are in doubt, their proper accounting treatment should be determined at the time the accounts are prepared by taking into account the facts known at that time.

62. In the Notice of Appeal, the Taxpayer claimed the assessments were excessive in that (1) there was an error in the Taxpayer' s tax returns because they were not prepared in accordance with the practices which prevailed at the time, that is, to apply the management fee adjustment acceptable to the Revenue as per DIPN No 24 and (2) the income in dispute was non-commercial in nature and should not be chargeable to profits tax under section 14 of the IRO. It asserted that ' Although DIPN No 24' s emphasis was on the deductibility of the management fee for firm and company under common control, it was prevailing practice that cost plus principle was used in accounting for the taxability of the management fee for the company. As the tax computations for

the said returns were not prepared in accordance with practices which prevailed at the time, that is, post DIPN No 24, correction should be made to the returns.'

63. During the hearing, the Representatives submitted that the assessment to profits tax for the years of assessment 1995/96 and 1996/97, was excessive by reason of an error in the calculation of the assessable profits in the tax computation. The error was the Taxpayer's failure to exclude in the tax computation the non-taxable portion of the management fee income which it received from the Firm. The Taxpayer claimed that since the transactions between the Firm and the Taxpayer lacked commercial purpose, the management fee income derived therefrom was not taxable under section 14 of the IRO. The Taxpayer claimed that the inclusion of the management fee income in the tax computation was an error within the ambit of section 70A of the IRO, for the purpose of re-opening the assessment for the year of assessment 1995/96.

64. It appeared that the claim in the Notice of Appeal that there was an error in the tax returns because 'the cost plus principle' set out in DIPN No 24 was not used, was no longer pursued at the hearing. The Representatives made no reference to it in its submission. On the other hand, in contending that the alleged error was an error within the meaning of section 70A, the Representatives acknowledged that 'the Commissioner had already stated in DIPN No 24 that management fee income to a service company would be treated as fully taxable', thereby refuting its former claim that there was an error in the management fee income because the cost plus principle was not used.

65. Since the Taxpayer did not pursue this claim, we need not concern ourselves with it. Had the Taxpayer pursued it, it would have failed in this regard. DIPN No 24 was issued in 1995 as a result of the Government's wish to crack down on certain artificial service company arrangements. It seeks to clarify the legal basis under which the Revenue would challenge Type II Service Company arrangements which 'typically involve deductions being claimed by an unincorporated business for payments, often described as management fees, which are made to a company or a trust ("Service Company") controlled by the proprietor or partners of the business'. For this obvious reason, we agree with the Respondent's submission that DIPN No 24 had no application to the Taxpayer's case. The whole tenor of DIPN No 24 is on the question of whether or not the management fee paid or payable by an unincorporated business to a service company can be allowed as a deduction in the unincorporated business' tax file. It does not deal with the chargeability of the management fee paid or payable, to a service company in the service company's tax file. The 'cost plus principle' set out in DIPN No 24 is for determining the maximum allowable amount of the management fee paid or payable by an unincorporated business to a service company, and has no application for the purpose of chargeability of the management fee to the service company. Thus, the claim that 'it was the prevailing practice that the cost plus principle was used in accounting for the taxability of the management fee for the company' and an error was caused by the failure to apply 'the cost plus principle' must fail.

66. Having disposed of the Taxpayer's first claim under its grounds of appeal, we now come to its other claim that 'the income in question was non-commercial in nature and should be excluded as taxable income under section 14 of the IRO.'

67. The Taxpayer agreed that the management fee income would be taxable if it was income derived from the carrying on of a trade or business within the meaning of section 14 of the IRO. However, it contended that the transactions between the Firm and the Taxpayer lacked commercial purpose and its income therefrom was not trading profits chargeable to tax under section 14 of the IRO. The Taxpayer's reasons for its contention are set out fully in paragraphs 20(f), 28, 29, 30 and 31 above. We do not intend to repeat them here. We have considered them carefully. However, we are not persuaded by the Taxpayer's arguments. We disagree that the transactions between the Firm and the Taxpayer had no commercial basis. For the purpose of assessing the Firm's tax liability, the Revenue was not satisfied that the management fees paid by the Firm to the Taxpayer was commercially realistic by reason of section 17(1)(b) of the IRO. At no time were the transactions regarded as non-commercial in nature. The Taxpayer's management fee income might be commercially unrealistic but it did derive from commercial transactions and was assessable to profits tax under section 14 of the IRO. We agree with the Respondent that the management fee income was trading profits and was subject to profits tax under section 14 of the IRO. We endorse the Respondent's reasonings as set out in paragraphs 35, 36 and 37 above.

68. The Taxpayer submitted that the income could not be regarded as trading income but it was more like a gift in nature. In the context of the Firm, the management fee or the overpayment of it might well be regarded as a gift from the Firm to the Taxpayer. However, in the context of the Taxpayer, the management fee with or without adequate consideration was nonetheless received by the Taxpayer as management fee income in the course of its stated business and it was also treated by it as a business receipt in its accounts and was thus taxable.

69. As to the Taxpayer's contention that there was no need to physically transfer back the alleged non-taxable part of the management fee income to the Firm because the Firm had already treated that part of the management fee paid as a partner's drawings, we do not find this contention helping the Taxpayer's case. The Firm and the Taxpayer are two separate legal entities. The state and nature of the Taxpayer's accounts which had been audited by its Representatives and signed by its directors as correct, cannot be altered retrospectively by a simple book entry in the Firm's accounts. Furthermore, if there were any agreements between a partner or partners of the Firm and a director/shareholder of the Taxpayer, those agreements would be personal to them and should not affect the respective rights and obligations of the Firm and the Taxpayer.

70. We have also considered the classes of profits and gains which are exempted from tax under the IRO. The management fee income in question does not come under any of those exempted classes.

71. Since we have found that all the management fee income received by the Taxpayer were trading profits and should be chargeable to profits tax under section 14 of the IRO, it follows that the alleged error of not excluding the non-taxable portion of the management fee income in the tax computation does not arise. Since there was no error, section 70A of the IRO cannot be invoked for the purpose of re-opening the assessment for the year of assessment 1995/96.

72. Accordingly, for the aforesaid reasons, we find that the Taxpayer has failed to discharge the onus on it to prove that the assessments to profits tax were excessive under the circumstances. The appeal is hereby dismissed.