INLAND REVENUE BOARD OF REVIEW DECISIONS

**Case No. D68/03**

**Salaries tax** – salaried partner – whether partner or employee.

Panel: Ronny Tong Ka Wah SC (chairman), Patrick James Harvey and Liu Ling Hong.

Dates of hearing: 16 and 17 September 2003.
Date of decision: 15 October 2003.

At all material times, the taxpayer was a salaried partner of a firm of solicitors ('the Firm'). The main issue is whether he was a partner (equity partner) or just an employee of the Firm.

In the hearing before the Board, the taxpayer elected not to give evidence but relied on various documents to support his contention that he was an equity partner.

**Held:**

1. Without the direct evidence coming from the taxpayer, the Board could only consider the documents in reaching its conclusion.

2. There was no written agreement between the taxpayer and the Firm as regards his position.

3. The Board considered the status of a 'salaried partner' which denoted actually an employee and distinguished it from a true partner (equity partner) (Kao, Lee & Yip v JR Edwards and Stekel v Ellice considered).

4. The Board was of the view that one of the important considerations in determining whether one is a partner is whether he shares the profits and bears the risk of loss (Ross v Parkyns and Stekel v Ellice considered).

5. All the documents showed that there was no sharing of profits or loss by the taxpayer. Besides, the taxpayer admitted that he had not contributed towards the Firm's capital.

6. The Board found the taxpayer failed to discharge his burden in showing that he was in fact a partner instead of an employee.

**Appeal dismissed.**

Cases referred to:

Ross v Parkyns (1875) 20 LR Eq 31
Stekel v Ellice [1973] 1 All ER 465
Kao, Lee & Yip v JR Edwards [1994] 1 HKLR 232

Yvonne Cheng Counsel instructed by Department of Justice for the Commissioner of Inland Revenue.
Taxpayer in person.

**Decision:**

**Background**

1. The facts of this appeal are strange. The Taxpayer claimed that he was a partner to a firm of solicitors (' the Firm' ). His ' partners' , however, claimed that he was not.

2. The Taxpayer is a solicitor. He joined the Firm on 1 November 1991 as an assistant solicitor. He claimed that he became a partner of the Firm on 1 February 1992. By that, he meant that he was an equity partner and not a salaried employee commonly referred to as a salaried partner of the Firm.

3. The Taxpayer received income from the Firm through a service company of the Firm (' Company A' ). On diverse dates, Company A filed employer' s returns of remuneration and pensions for the years ended 31 March 1995 to 1998 showing two companies, Company B and Company C as employees respectively.

4. There is evidence that both Companies B and C were under the control of the Taxpayer but since it was freely admitted that the income never went to either Company B or Company C but to the Taxpayer direct, we feel we could ignore Companies B and C for the time being. They became relevant in a slightly different context later on. We will deal with that in due course.

5. The income allegedly received by Company B from the Firm was assessed as the Taxpayer' s income from an employment with the Firm and on 29 March 2001, the Commissioner

raised on the Taxpayer the following salaries tax assessment for the year of assessment 1994/95 (' the 94/95 Assessment' ):

**The 94/95 Assessment**

| | $ |
|---|---|
| Estimated assessable income | 1,744,885 |
| Tax payable thereon | 261,732 |

6. The Taxpayer objected and submitted a tax return - individuals for the year of assessment 1994/95 wherein he declared that he did not have any assessable income chargeable to salaries tax.

7. The Commissioner was of the view that the Taxpayer was a salaried partner/employee of the Firm and the income derived from the Firm should be chargeable to salaries tax. On 14 March 2002, the Commissioner raised on the Taxpayer the following salaries tax assessment for the years of assessment 1995/96 to 1998/99 (' the 95/96 to 98/99 Assessment' ):

| **Year of assessment** | **1995/96** | **1996/97** | **1997/98** | **1998/99** |
|---|---|---|---|---|
| | $ | $ | $ | $ |
| Assessable income | 1,907,856 | 2,198,096 | 2,195,589 | 305,113 |
| Less: Allowance | | | | 108,000 |
| Net chargeable income | | | | 197,113 |
| Tax payable thereon | 286,178 | 329,714 | 296,404 | 23,009 |

8. The Taxpayer objected to the 95/96 to 98/99 Assessment on the same ground that he was a partner of the Firm and should not be chargeable to salaries tax. His position was that since tax had already been paid by the Firm in discharge of its profits tax liability, he should not be liable for any further tax.

9. The 95/96 to 98/99 Assessment was subsequently slightly revised to take into account further income received by the Taxpayer in the years of assessment 1997/98 and 1998/99 as a member of the Board of Review but no dispute arose out of that revision.

10. The Commissioner in a determination dated 13 February 2003 (' the Determination' ) rejected the Taxpayer' s objections and affirmed the 94/95 Assessment and the 95/96 to 98/99 Assessment as revised. The Taxpayer now appeals against the Determination.

**The hearing**

11. Despite having been explained of his burden under section 68(4) of the Inland Revenue Ordinance (Chapter 112) ('IRO') and repeated invitations from the Board, the Taxpayer declined to give evidence. In the circumstances, he had effectively deprived the Board of any direct evidence as regards the matters asserted in this appeal and we could only consider the documentary evidence in light of the Taxpayer's submissions. This we find to be a very unsatisfactory way of resolving the appeal since the Taxpayer's credibility is very much in issue here. Be that as it may, we have warned ourselves not to draw any adverse inference against the Taxpayer unless such inference is inevitable in the absence of any credible explanation.

**The law**

12. The difficulty of this appeal is that there was no written agreement between the Taxpayer and the Firm as regards his position after 1 February 1992 when his status apparently changed. In the circumstances, we can only look at all the surrounding circumstances including the contemporaneous documents and the conduct of the parties to ascertain their true intention as regards the Taxpayer's status (see Ross v Parkyns (1875) 20 LR Eq 31 at 335; Stekel v Ellice [1973] 1 All ER 465 at 473d-g). In this regard, self-serving statements of the parties are relevant but not conclusive. The truthfulness of such statements must be considered in light of the surrounding circumstances. In response to a question from us, both the Taxpayer and the Revenue agreed that this is a proper approach to be adopted by the Board in the circumstances.

13. An important question to remember is whether the person claiming to be a partner shares the profit and loss of the commercial relationship.

14. Section 3(1) of the Partnership Ordinance (Chapter 38) ('PO') defines 'partnership' as '*the relation which subsists between persons carrying on a business in common with a view of profit.*'

15. Section 4 of the PO sets out a number of rules which are to be used in determining whether a partnership exists:

> '...
>
> *(b) the sharing of gross returns does not of itself create a partnership ...*
>
> *(c) the receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business, but the receipt of such a share, or of a payment contingent on or varying with the profits of a business, does not of itself make him a partner in the business; and in particular –*

*(i) the receipt by a person of a debt or other liquidated amount ... out of the accruing profits of a business does not of itself make him a partner in the business or liable as such;*

*(ii) a contract for the remuneration of a servant or agent of a person engaged in a business by a share of the profits of the business does not of itself make the servant or agent a partner in the business or liable as such ...'*

16. Miss Cheng who appeared for the Revenue submitted that:

(a) Where there is a right to share in the (net) profits of the partnership, there is a presumption of a partnership: Ross at 335. However, it is not determinative. In Ross, the plaintiff received a share of profits, but bore no risk of losing more than the profits. The Court held he was not a partner.

(b) Labels are not conclusive. That said, the word 'salary' is indicative of an employer-employee relationship and ' is not applicable between partners *inter se*': Ross at 335-6.

(c) Whether a person shares the *net profits*, and bears the *risk of loss*, are important considerations in determining whether he is a partner.

(d) The distinction between net profits and gross profits is important. A partnership is a business with a view to profit. Remuneration by way of a fixed portion of gross profits or revenue is *not* indicative of a partnership, because the recipient receives this amount no matter whether the business makes a profit or a loss. The recipient is unaffected by the level of expenses of the business. He does not have to concern himself if the business' expenses exceed its gross receipts. He does not have a direct incentive to improve the efficiency of the business, because no matter what the expenses are, his salary will not vary.

(e) Similarly, whether the person bears a risk of loss is important because it is the corollary of the potential for profit. The essence of partnership is that the partners are in business for their own account: they aim to make their gross receipts exceed their outgoings (and thereby make a profit), and run the risk that their aim is not met (thereby leading to a loss).

17. We agree.

18. Another important aspect is that the fact that a person is held out to the world to be a partner is never conclusive. There can be a host of reasons why he is so held out. In particular, in

the legal field, a salaried employee is often held out as a partner because it would be a matter of face to him in the eyes of the client that he is not just an assistant solicitor; or to make the client feel that he is being served by a senior member of the firm. Very often, a salaried partner works just as hard as any other true equity partner to improve the firm' s fortunes. But that is no more than a natural consequence of an employee wishing to indirectly protect his own job; or to enhance the employer' s impression of him so as to pave the way for better employment terms or even a chance to be promoted to the ranks of a true equity partner.

19. It is also not unusual for solicitors' firms to take on someone with potential to become a full equity partner as a salaried partner first for a certain period. In this period, the salaried partner is rather like ' on probation' . During this period, it may be unfair to the employee in that he may assume a liability as an equity partner to the outside world when in truth he is but an employee. But that is the risk he has to take and more often than not, is willing to take.

20. If there is any protection for such a person, such protection often comes in the form of a cross indemnity from the employer. Again, this is not unusual. Such indemnities are often part of the employment agreement and expressly set out. But there is no reason why such indemnity cannot be implied either by the surrounding circumstances or as a matter of law where there is no express agreement in writing. After all, there is always an implied internal cross indemnity even between true equity partners in proportion to their respective shares in the partnership although to the outside world, each partner is responsible for the full liability of the firm.

21. Where the salaried partner is liable for the liability of the firm, his liability really arises by reason of the holding out that he is a partner rather than because the terms of agreement make it so. Thus, the fact that he is being held out to the world as a partner can sometimes mean that he is a real partner but equally it can mean he is just a salaried employee but for commercial reasons held out to be a partner.

22. In Kao, Lee & Yip v JR Edwards [1994] 1 HKLR 232 at 235 lines 14 to 24, Litton JA said, '*... The defendant was held out to the outside world, and apparently to the staff members of the firm itself, as a partner. His name appeared in the firm' s letterhead as a partner, and he was introduced to clients of the firm, and attended social functions, as a partner. The result of this contractual arrangement was that, in law, the defendant would have been liable for the firm' s debts as a partner by virtue of the holding out, but he enjoyed none of the benefits of partnership except, possibly, the "prestige" which attended his status ...*'

23. Also at 239 lines 20 to 24, the learned judge continued: '*For, despite all outward appearances, the defendant was in the position of an employee of the firm and, in the returns made by the firm to the Inland Revenue Department, was so categorised. In a sense, he had the worst of both worlds. He had no share in the profits of the firm and yet, by being held out as a partner, incurred the legal liabilities of a partner.*'

24. Likewise in Stekel v Ellice [1973] 1 All ER 465 at 472b-c, Megarry J said, *'The term "salaried partner" is not a term of art, and to some extent it may be said to be a contradiction in terms. However, it is a convenient expression which is widely used to denote a person who is held out to the world as being a partner, with his name appearing as partner on the notepaper of the firm, and so on. At the same time, he receives a salary as remuneration, rather than a share of the profits, though he may, in addition to his salary, receive some bonus or other sum of money dependent on the profits. Quoad the outside world it often will matter little whether a man is a full partner or a salaried partner; for a salaried partner is held out as being a partner, and the partners will be liable for his acts accordingly. But within the partnership it may be important to know whether a salaried partner is truly to be classified as a mere employee or as a partner.'*

**Contemporaneous documents**

25. Bearing these points in mind, we now turn to the documentary evidence.

**' To Whom It May Concern' letter**

26. On 9 December 1994, Miss D, senior partner of the Firm, signed a letter headed ' To Whom It May Concern' (' the Letter'). The Letter purported to ' certify' that:

(a) the Taxpayer was ' admitted a Partner' of the Firm on 1 February 1992;

(b) his remuneration consisted of:

(i) ' monthly salary' of $90,000, on a 13-month per year basis;

(ii) 30% commission in respect of legal fees derived from his own clientele; and

(iii) ' profit sharing in respect of certain practice areas' .

27. The Taxpayer did not dispute the Firm' s suggestion that the Letter was written by him for Miss D to sign. He did dispute, however, that it was prepared for the purpose of applying for a visiting visa for an overseas trip. He insisted that the Letter reflected correctly the position between him and the Firm. He further admitted, upon probing from us, that the ' profit sharing' was in fact a fee calculated on the basis of 2% of the receipts of certain practices of the Firm with a minimum of $10,000 per month. In essence, the ' profit sharing' was only a form of commission.

28. What the Letter shows is that despite the fact he was described as a ' partner' , the Taxpayer was paid a salary for his services. The significance of this is that there was no sharing of

either profit or loss by the Taxpayer. Whether the Firm was practising profitably had no relevance to the Taxpayer's income. He would continue to receive his pay by way of salary and commission.

29. This coupled with the fact that on the Taxpayer's own admission he had not contributed towards the Firm's capital strongly suggested that he was not an equity partner of the Firm.

30. There is another fact which supports this *prima facie* conclusion. Upon his departure, there was no evidence that the Firm was wound up or that a new partnership was formed. The Taxpayer was never informed nor was he ever concerned as to what were the profits or losses of the practice in the period before he left. No accounts were made available to and no provisions were made for the Taxpayer to share in the fortunes of the Firm over the years while he was a 'partner'.

31. Indeed, it was alleged by the Firm and not disputed by the Taxpayer that the internal accounts of the Firm were never shown to the Taxpayer. He insisted he took part in various partners' meetings and had a cordial relationship with the partners. He also asserted, without giving evidence, that he was consulted on all aspects of the practice and administration of the Firm. But significantly, he had no access to the financial statements of the Firm. He freely admitted that he 'trusted' his 'partners' and left all calculations as to his income entitlement to them. The Firm had not opened nor maintained any partner's current account for the Taxpayer in its books. He was not a signatory to Company A's bank account.

**Employer's returns**

32. Strangely, the Taxpayer's 'partners' did not share his view that he was an equity partner of the Firm. We find this position most disturbing. If the Taxpayer was truly a partner, and as he repeatedly asserted, he parted company with the Firm amicably, why did his partners disown him? How can someone be a partner of a partnership without the agreement or consent of the other partners to the partnership?

33. The Taxpayer hinted that there was a financial angle to the Firm's position. The Firm had been deducting the salaries of the Taxpayer as an expense item. But, as reflected by the Letter, this was what the parties apparently agreed. The logical conclusion to this suggestion seemed to be that the Taxpayer and the Firm had conspired to defraud the Revenue by pretending that profits distributed to the Taxpayer was disguised as salaries paid to an employee. We are not prepared to accept such a suggestion without the clearest evidence.

34. The documents, however, suggest that it was at the Taxpayer's suggestion that the payment arrangements were made as it was. The employer's return in 1995 was filed by Company A showing that salaries and commissions were paid to Company B. From 1996 to 1998, employer's returns were filed showing Company C as the employee.

35. The Taxpayer would not admit that he was in control of Company B in the year of assessment 1994/95 or that he gave oral instructions to Company A to pay salaries to Companies B and C. He agreed, however, that Company C was a company under his control. He could not, however, explain why salaries which were never received by Companies B and C were in fact received by him. We find it incredible that this arrangement was not initiated by him.

36. The Taxpayer originally admitted he had seen these returns but perhaps not at the time. He later reneged and said he was not sure if he ever saw these returns. This would be a remarkable situation if true: the Firm pretended that salaries were paid to companies which must be under the control of the Taxpayer when in fact he was receiving the salaries without knowing that his companies were involved. Why would the Firm do a thing like that? Who suggested the names of the companies? We have no doubt that the Taxpayer was being economical with the truth here.

37. Whether the companies were interposed for a tax benefit for our present purposes is perhaps irrelevant. What is pertinent is that the Taxpayer had received salaries in the names of his companies as an employee.

**Consultancy agreement**

38. There is a document in the bundle described as a consultancy agreement dated 6 March 1996 (' the Agreement' ). It is common ground that the Agreement was never performed. However, the form in which it was executed is most revealing.

39. By the Agreement, the Firm agreed ' to employ [Company C]' for ' consulting services in connection with the management and business of [the Firm]' . The Taxpayer stressed that the services were not services which could only be provided by a qualified legal practitioner. That must be right since Company C was not a legal practitioner. The Taxpayer, however, despite repeated questions from the Board, could not explain why the Agreement was made in the first place and what was the intention behind it.

40. What is clear from the terms of the Agreement is this. The Taxpayer had suggested to the Firm that the latter should employ Company C and pay to it salaries for services which were really provided by the Taxpayer and the Firm agreed. This was plainly a device to achieve tax benefit for the Taxpayer. Why should he do that if he were truly an equity partner of the Firm?

**Internal memoranda**

41. Some of the Firm' s internal memoranda have been produced and are before us. These were all documents which the Taxpayer agreed he had seen at the time.

42. It is instructive to note that in a memorandum dated 30 March 1992, two months after the change of status of the Taxpayer, Miss D gave consent to reimburse the Taxpayer of certain entertainment expenses and said, ' With effect from 1/4/92, [the Taxpayer' s] *salary* to remain ... plus 2% on Imm, Commercial & Trusts … with a minimum of $10,000 per month, to be calculated at the end of every 6 months.' (emphasis added)

43. In another undated memorandum, someone wrote:

> ' 1. Effective 1/11/92 $70,000 salary + 2% on commercial etc (3 months)
>
> 2. Continue to work.'

44. In a memorandum dated 9 November 1993, the Taxpayer wrote:

> ' Another 12 happy months have passed and it is that time of year again to renew my compensation package. Shall I leave the matter in your fair hands to decide on a fair and equitable arrangement effective from November 1993 onwards? Thanks.
>
> By the way, since I shall be away for 1 week next week, kindly consider asking [a named person] to calculate my November commission so that I can utilise the same to pay my household bills before I go.
>
> Thank you.
>
> [name of the Taxpayer].'

45. Miss D wrote a note underneath the above:

> ' Effective 1/11/93
>
> (1) $70,000 to $80,000
>
> (2) 2% on Probate – if he remains (illegible).'

46. The tone and words used by the Taxpayer were hardly those of an equal partner speaking to another but rather those of a subordinate employee speaking to his superior employer.

47. In another memorandum dated 27 May 1994, Miss D wrote:

> ' Please note that 2% on probate matters for [the Taxpayer] stops.

> Calculated up to end of May, 1994 since [another named person] has taken over Probate Matters. Thank you.
>
> P/S Pls file this in [the Taxpayer's] personal file.'

48. It therefore seems that the Taxpayer's salary entitlements were entirely at the discretion of the Firm and his records were not kept together with the partnership's files but his 'personal file'. This is in line with the Taxpayer's admission that unlike other partners, he did not have a current account with the Firm.

49. In another memorandum dated 27 October 1994, the Taxpayer's salary was increased from $80,000 to $90,000 from 1 November 1994. In yet another memorandum dated 29 November, the Taxpayer's salary was increased to $100,000 effective November 1995.

50. Then in another memorandum dated 13 November 1997, the Taxpayer wrote:

> 'Re: Remuneration
>
> In view of the current economic climate, I am willing to freeze my salary at the current level for the coming year.'

The Taxpayer thus did not himself regard his income as drawings but simply salaries, there was no suggestion that other partners also 'freezed' their drawings.

51. There were also at least four memoranda by which the Taxpayer enquired about his leave entitlements in tone and language only consistent with an employee asking for permission to take leave.

**Agreement in 1998**

52. There was an agreement in writing between the Taxpayer and the Firm dated 15 April 1998. By this agreement, it was agreed that the Taxpayer should receive $35,000 per month plus other commissions as a 'Partner (salaried)'.

53. The Taxpayer claimed that he was 'pressured' into signing this agreement. He pointed out that he left soon thereafter. He wrote a note on 19 May 1998 resigning from the Firm in rather amicable terms.

54. Whether he was 'pressured' or not, it is nothing short of remarkable that if he were truly an equity partner he would agree to such a drastic reduction of his salary and still managed to agree to part company with his partners in such amicable terms. Furthermore, as we have already observed above, there was no demand to wind up the affairs of the partnership nor the preparation

of full accounts to finally settle the entitlements of the various partners upon dissolution of the partnership. Indeed, there was no demand for the dissolution of the partnership.

55. These two documents, as also the other contemporaneous documents we have considered above, are only consistent with the Taxpayer being a salaried employee rather than an equity partner of the Firm.

**Company E**

56. In the years of assessment 1991/92 and 1992/93, a company (' Company E' ), agreed to be under the control of the Taxpayer, received certain payments from the Firm. The assessor raised on Company E profits tax in respect of these payments. Company E did not object to these assessments which became final and conclusive in terms of section 70 of the IRO.

57. It must be inferred from the above that the Taxpayer had accepted that income from the Firm paid to Company E should be treated as taxable income in the hands of Company E rather than profits of the Firm, and not as income of an equity partner.

**Guarantees to the Bank**

58. In 1998, before the Taxpayer left the Firm, the Firm had to apply for a tax loan from a bank (' the Bank' ). In a letter to the Bank, the Firm disclosed to the Bank the respective names of the three equity partners of the Firm and their respective equity shares in the Firm. The Taxpayer was not one of them. Further, each of the three equity partners named gave a guarantee to the Bank but the Taxpayer did not.

59. Interestingly, at the back of the guarantee, there is a form called ' For Partnership' which binds ' all the partners' of the Firm. This document, however, draws a distinction between ' partners' and ' sharing partner' . The signatories to this document were described as ' ALL Partners in full' and the Taxpayer' s name was added by fair hand rather than typed as the others.

60. In our view, this is just another example of the well established distinction between a salaried partner and a full equity partner.

**Holding out**

61. The Taxpayer mainly relied on documents where he was described as a ' partner' . Some of these have been examined above. Others are mainly documents to the outside world whereby the Taxpayer was held out as a partner. We have already considered this aspect of the case and we are of the view that these documents by no means displace the proper inference to be drawn from the documents above which overwhelmingly point to the conclusion that the Taxpayer was an employee described as a ' salaried partner' and not an equity partner of the Firm.

62. The Taxpayer placed particular emphasis on the professional indemnity insurance (' the Insurance' ) taken out by the Firm which described the Taxpayer as a ' partner' . In our view, this is no different from other documents to the outside world whereby the Taxpayer was held out to be a partner.

63. However, ever then it will be useful to note the effect of the Insurance. First, the insurance is not a cover simply for an equity partner but for the entire firm. What the insurers were concerned with most was what was the amount of each claim covered and not whether the claim arose out of the conduct of a partner or an employed solicitor.

64. Secondly, the ' indemnified' was defined to include *'any principal in the firm'*. ' Principal' was in turn defined as meaning a partner or sole practitioner and any solicitor held out as a partner or sole solicitor: see Solicitors (Professional Indemnity) Rules (Chapter 159M), rules 2 and 10.

65. We do not think the Insurance is particularly relevant in this context either.

**Conclusion**

66. In these circumstances, having carefully weighed up all the evidence, we have come to the finding that the Taxpayer has failed to discharge his burden under section 68(4) of the IRO in showing that the assessments appealed against are excessive or incorrect. The Determination is affirmed.

67. The appeal must, therefore, be dismissed.