INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D76/90

Salaries tax – deduction of expenses – night club mamasan – section 12(1)(a) of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Philip Fu Yuen Ko and Charles Hui Chun Ping.

Dates of hearing: 9, 22 November and 21 December 1990.
Date of decision: 22 March 1991.

The wife of the taxpayer was employed as a public relations manageress or mamasan of a night club. She claimed that she had incurred certain expenses which should be deducted from the remuneration which she received and which was assessable to salaries tax. The assessor refused to allow the expenses but allowed a reduction of 10% from her remuneration as an arbitrary sum. The taxpayer rejected the 10% reduction and appealed to the Board of Review.

Held:

The wife of the taxpayer could neither prove to the satisfaction of the Board that she had incurred all of the expenses claimed nor that those expense proved were incurred by her wholly, exclusively and necessarily in the production of the assessable income as required by section 12(1)(a). As the Board had heard detailed evidence of every expense claimed and had disallowed the same it was not appropriate that a lump sum 10% deduction should be given.

Appeal dismissed and reduced assessment overruled.

Cases referred to:

CIR v Humphrey 1 HKTC 451
D25/87, IRBRD, vol 2, 400
Lomax v Newton 34 TC 558
Ricketts v Colquhoun 10 TC 118
CIR v Burns 1 HKTC 1181
Brown v Bullock 40 TC 1
CIR v Sin Chun-wah 2 HKTC 364
Nolder v Walters 15 TC 380
Pook v Owen [1967] 2 All ER 579

H Bale for the Commissioner of Inland Revenue.
Robert Lew for the taxpayer.

Decision:

This is an appeal by a taxpayer against a decision by the Commissioner refusing to permit the deduction of certain expenses claimed to be incurred by the Taxpayer's wife when earning her income subject to salaries tax. The facts are as follows:

1. The wife of the Taxpayer was employed as a public relations manageress or mamasan by a night club in Hong Kong.

2. For salaries tax purposes, the remuneration received by the wife from her employment was included in the salaries tax assessment of the Taxpayer.

3. The wife had registered herself under the Business Registration Ordinance as carrying on a self-employed business and claimed that the income which she received as an employee should be taxed as profits of her business. This was not accepted by the assessor who assessed the income of the wife to salaries tax. The Commissioner's determination from which the Taxpayer has appealed included a determination against the Taxpayer who was claiming that the income of his wife was not salary and should not be assessed to salaries tax. However, at the hearing of this appeal, the Taxpayer did not challenge the determination of the Commissioner in this regard and conceded that the income of the wife was assessable to salaries tax and not to business profits tax. Accordingly we have found as a fact that the wife was employed and earning income assessable to salaries tax.

4. The terms of service of the wife were set out in a Chinese document entitled 'service regulations for mamasans'. The following is a summary of some of the important terms set out therein. The nature of the employment of the wife and the services provided by her were that she was required to work at the night club from 8 pm to 3 am. She was required to have working under her but employed by the night club a number of hostesses who were supervised by her. Her remuneration was based on commission paid to her which commission was in turn based upon the number of chargeable units of time which as hostess earned for the night club. There was a complex set of rules covering the way in which customers could be introduced to the hostesses working under the wife and also for existing customers who wished to use the services of hostesses working under the wife.

5. The Taxpayer claimed that his wife in the course of hr employment incurred certain expenses which should be deducted from her income assessable to

salaries tax in accordance with section 12(1)(a) of the Inland Revenue Ordinance. The Commissioner upheld the assessment and decided against the Taxpayer because no details and explanations of the circumstances in which the expenditure was incurred had been provided and in any case a majority of the expenses claimed appeared to the Commissioner to be of a private or domestic nature. He allowed a concession suggested by the assessor of granting an arbitrary percentage deduction of 10% from the taxable income of the wife to accord with an Inland Revenue Departmental practice.

At the hearing of the appeal, the wife, a manager employed by the night club, and a hostess employed by the night club who was working under the wife were called to give evidence. A number of vouchers were produced to the Board of Review which it was stated on behalf of the Taxpayer came into two classes and seven categories. The first class comprised money deducted by the employer from the sums earned by the wife and accounted for by promissory notes. This class of claimed expenses was divided into five categories, namely, drinks for customers, payments on behalf of customers who did not have enough money, bills paid on behalf of a customer who was supposed to repay the money to the wife and failed to do so, payment by the wife of outside escort charges which were supposed to have been paid by one of the hostesses to the night club but were not paid, and loyalty payments in the form of compensation to keep the hostesses. The second class comprised credit card payments made by the wife. This class of claimed expenses was divided into two categories, namely, meal costs to keep the hostesses together between shifts and taking hostesses out to talk about business.

As the representative for the Taxpayer presented his case on the basis that the deductions claimed from the income assessed to salaries tax fell into these seven categories we will deal with each category in turn. It is also appropriate to deal with the evidence separately under each heading. However, before doing so, we refer to the legal principles involved.

The law with regard to expenses which can be deducted from income subject to salaries tax is quite clear. Section 12(1)(a) of the Inland Revenue Ordinance states that there shall be deducted from the income assessable to salaries tax:

> ‘ 12(1)(a) all outgoings and expenses, other than expenses of a domestic or private nature and capital expenditure, wholly, exclusively and necessarily incurred in the production of the assessable income.’

There are many leading cases which make it clear that the deductions permitted for salaries tax purposes are very limited. Expenses must not be of a domestic or private nature. Furthermore they must be wholly incurred in the production of the assessable income, they must be exclusively incurred in the production of the assessable income and in addition they must be necessarily incurred in the production of the assessable income. The words ‘wholly’, ‘exclusively’, and ‘necessarily’ each stand alone and must be given their full meaning. They are not one expression. Before an expense can be deducted, it must

comply with all three tests. The word 'wholly' means that if an expense is incurred partly for the production of the assessable income but partly for the benefit of the taxpayer or any other person, the expense is not deductible. It does not matter if the principal object of the expense or the majority of the expense is attributable to the employment. It must be 'wholly' attributable to the employment.

The word 'necessarily' has also been given a very precise interpretation. The expense must be necessarily incurred in the production of the assessable income. This means that this test has two limbs. The expense must be something which the employee must incur and has no choice. If there is any choice, then it is not necessarily incurred. Secondly it must be necessarily incurred in the production of the assessable income. This means that it is not sufficient for the employment contract or employer to impose a condition upon the employee if the expense is not incurred in the production of the assessable income.

It should also be noted that section 12(1)(a) of the Inland Revenue Ordinance refers specifically to outgoings and expenses incurred 'in the production of the assessable income'. There is a subtle but important distinction between these words and, for example, the words 'for the purpose of producing the assessable income'.

In the course of the hearing, we were referred to the following cases:

CIR v Humphrey 1 HKTC 451

D25/87, IRBRD, vol 2, 400

Lomax v Newton 34 TC 558

Ricketts v Colquhoun 10 TC 118

CIR v Burns 1 HKTC 1181

Brown v Bullock 40 TC 1

CIR v Sin Chun-wah 2 HKTC 364

Nolder v Walters 15 TC 380

Pook v Owen [1967] 2 All ER 579

First we deal with drinks for customers. In her evidence the wife said that she was given an allowance by the night club in respect of drinks for customers but the amount was not sufficient. She produced vouchers in the form of promissory notes which she said related to drinks which she had purchased for customers in excess of the allowance given to her by the night club. We find the evidence of the wife to be unsatisfactory. A fellow employee of the wife was called to give evidence. He was one of many managers employed

by the night club and claimed to have been the person who wrote the regulations under which all mamasans worked. He had no authority to represent the night club, had little or no knowledge about the accounts and affairs of the night club and was not a senior executive or director in charge of the business of the night club but was only one of some twenty or more similar managers. With regard to the claim that the wife had incurred expenses in purchasing drinks for customers, we consider his evidence to be of no value at all.

On the evidence of the wife, we are not satisfied as to the nature of the payments which she alleged she had made to buy drinks for customers and furthermore even if she did buy such drinks for customers we are not satisfied that they were necessarily incurred by her in performing the duties which she was employed to perform. On her own evidence, we have the statement that the night club made an allowance to the wife in respect of drinks for customers. We have no evidence from the night club as to whether or not the allowance was or was not sufficient as claimed by the wife.

If the arrangement between the night club and the wife was that the night club would only pay for some of the expenses incurred by the wife but not all of them and that the wife was required under the terms of her employment to incur such additional expenses, then the position might, and we emphasize the word 'might', be different. However, we have no such evidence. We do not know in what circumstances the wife would purchase drinks for customers, nor do we know the names of the customers for whom she purchased drinks. If it was a requirement of her employment that such drinks be purchased by her at her own expense, it would not have been difficult for someone representing the night club to have given evidence to this effect because according to the wife's evidence, the payments were made by means of a promissory note arrangement which enabled the night club to deduct the sums from the remuneration paid to her.

Another point is that if we were to accept what the wife alleged to be the terms or requirements of her employment, we would have the strange situation that the night club was making a profit from the wife by selling drinks to customers which were then paid for in full by the wife. We refer to this point later in relation to the claimed loyalty payments. Without clear evidence from the night club that they did operate a business whereby they made profits from their employees it would appear to be a strange relationship if we were to decide in favour of the wife. Surely the wife would have negotiated with her employer to purchase such drinks at cost. However, if the position was that the wife decided of her own volition and not as a necessary adjunct to her employment to pay for drinks ordered by customers then it would be natural for the night club to charge the full price to the wife because what she was doing was a private matter between herself and the customers. In such circumstances it would be natural for the night club to insist on making their normal profit.

The onus of proof is on the Taxpayer and we are far from satisfied with regard to this part of the claimed expenses. We reject this part of the claim by the Taxpayer.

We now come to the second category being the alleged payment made by the wife because the customer did not have enough money. Here again, we found the evidence

of the wife to be unsatisfactory and likewise the evidence of the manager to be of no assistance. It is obvious that the wife would not pay bills for customers unless she expected that the customer would subsequently repay the bill or unless it was a clear term of her employment. For such a claim to be successful, it would be necessary for the wife to keep full and accurate records of the times when she paid these bills, the names and particulars of the persons involved to enable them to be identified and evidence of the efforts which she had made to recover the moneys which she had in effect lent to or advanced on behalf of the customers. Evidence of the relationship between the wife and the customers would also be necessary because one would assume that the wife would not lend or advance money to someone who was totally unknown to her. None of this evidence was provided. Alternatively it would be necessary to have clear evidence given by someone representing the night club as to why the wife was required to make payment on behalf of the customers. No such evidence was called.

According to the service regulations of mamasans, the wife was responsible for making payment of any dishonoured cheques which were guaranteed by her and was required not to leave the night club if her own customers had not paid the bill. The regulations also say in this context that the night club would handle the matter in an appropriate manner. There is no mention in the regulations of the wife being required to underwrite her own or any other customers' bills. The service regulations further stated that the wife could not accept cash from customers and then charge the customer bills to her own account. This is a summary of three regulations of the service regulations of mamasans. There was no obligation imposed upon the wife to make payment on behalf of a customer who did not bring sufficient money. Indeed, one regulation suggests that it would be improper for the wife to have done so. We find the evidence of the wife to be far from satisfactory and we reject this part of the claim by the Taxpayer.

The third category of expenses is almost identical to the preceding one. It relates to bills which it is claimed were paid on behalf of a customer and not repaid by that customer to the wife. We do not accept the evidence of the wife with regard to this claim and the comments which we have made with regard to the preceding second category apply equally to this third category. If the nature of this part of the claim was that the wife was entertaining customers at her own expense then the comments which we have made with regard to the preceding first category also apply. Accordingly this part of the claim by the Taxpayer is rejected.

The fourth category relates to the alleged payment by the wife of outside escort charges. As we understand the nature of this claim, it would appear that a hostess working under the supervision of the wife might go out in the evening with a customer. It was the duty of the hostess concerned to obtain payment from the customer of the charges which were made by the night club for the services of the hostess. This fee was called an outside escort charge. According to the evidence of the wife, there were occasions when one of the hostesses for whom she was responsible failed to collect the outside escort charge from the customer. In such circumstances, the wife said she was required by the night club to make payment of the amount as part of her terms of employment.

With due respect we find once again the evidence of the wife to be unsatisfactory. We do not have any particulars regarding the nature of the amounts comprised in this claim. The names of the hostesses, the customers, the dates, and the circumstances involved are all missing. The action taken by the wife to recover the sums involved is also unknown. Regulation 18 of the service regulations of mamasans would appear to be the relevant regulation. It makes no reference to the requirement for the hostesses to collect the escort charge nor for the mamasans to guarantee payment. Indeed the regulation suggests that the night club will handle such matters because it would appear that it is the night club which requests a hostess to provide escort service. No explanation was given of regulation 18 by anyone representing the night club.

We would have thought that if a hostess was required to collect such payments on behalf of the night club and if she failed to do so and if as a result the wife were obliged to pay money to the night club, the wife would then arrange to collect the money back from the hostess in question or would refuse to allow the hostess to continue to work in the group of hostesses working under the wife. No evidence was given regarding disciplinary action taken by the night club or efforts made by the wife to recover the money from either the hostess in question or the customer. We are not satisfied with regard to the nature of this claim or the evidence given by the wife. Accordingly we reject it.

The fifth and final category of the first class of expenses is the so-called loyalty payment. Once again we found the evidence of the wife to be unsatisfactory. According to her evidence, it would appear that one or more of the hostesses for whom she was responsible decided to leave the employment of the night club and work for a different employer in the same line of business. In order to attract the hostess or hostesses back to work for the night club in the group for which the wife was responsible, the wife had to pay compensation to the hostess or hostesses to attract her or them back. To achieve this, the wife made a payment to the night club to cover the money which the hostess would have been able to earn for the night club had she been working for the night club at the time. Out of the money paid to the night club, the hostess then received the commission which would have been paid to her had she been working for the night club. Though evidence was not given regarding this, we are left to assume that likewise part of the money would have been repaid to the wife being the commission which she herself would have received on such business if it had taken place. With due respect to the wife and the representative for the Taxpayer, we cannot accept that such a claim has any substance. We do not accept the evidence given by the wife. We were told that the wife wished to attract the hostess or hostesses back into her group and that to do this, it was necessary that she paid her or them compensation. We cannot understand or believe that in order to pay compensation to the hostess or hostesses in question, the wife went through the tortuous procedure of making a substantial payment to the night club so that the night club could then pay commission to the hostess or hostesses in question. If such a strange arrangement were made, then much more explanation would be required from the wife and evidence would be required from the night club and the hostess or hostesses in question. In other parts of her evidence, the wife made it clear that she negotiated on a direct basis with hostesses to persuade them to join her group

and be employed by the night club. There is no evidence whatsoever to suggest that the night club required a 'loyalty payment' from the wife. All of the evidence was to the effect that the loyalty payment was made to the hostess or hostesses in question. However, the clear evidence by the wife was that she made payment to the night club as if the hostess or hostesses had been working for the night club and had been serving customers for the night club. Whatever was the nature of any payment that may have been made by the wife to the night club in respect of the hostess or hostesses, it was certainly not a loyalty payment as claimed by the wife. Accordingly we reject this part of the claim by the Taxpayer.

We now turn to the credit card payments. The first category of this class of alleged expenses related to entertaining the hostesses to keep them together between shifts.

It was claimed that the wife had to entertain the hostesses working under her in order to keep them together between the afternoon and evening shifts. It was claimed that it was necessary for the wife to take the hostesses out for a meal at the end of the afternoon shift otherwise they would not report for duty for the evening shift. The only evidence which was given was that of the wife and again we found it unsatisfactory. In giving evidence she referred to a number of credit card vouchers, referred to the name of the restaurant in question and deduced from the name of the restaurant that the expenses must have been incurred for the purpose of entertaining the hostesses so that they would report for work for the evening shift. There did not appear to be any pattern relating to this. If it was necessary to incur such expenses for this purpose, then presumably it was necessary to incur such expenses on a regular basis and presumably every day. However, the expenses were incurred irregularly and infrequently. Indeed there were twelve such items for varying amounts of between $190 minimum and $712 maximum. There is no pattern whatsoever and we are quite satisfied that whatever the nature of these expenses might have been, they were not as claimed by the wife.

As with all of the other claims made in this appeal even if we were to believe that the expenses had been incurred for the reasons stated, we would still not allow the expenses as being necessarily incurred and indeed in this instance wholly incurred. It would appear that the wife had entertained someone or more persons at her own expense and had presumably participated in the entertainment whatever it was. Accordingly it was probably not exclusively incurred for the purposes of the employment. Furthermore we have no evidence that it was necessary so far as the employer or the employment was concerned. Once again we have to point out that no witness with authority to represent the night club was called to give evidence. If it was necessary for the wife as part of her employment to provide food for the hostesses working under her then we would require clear evidence to this effect from the employer.

The second and final category in class two relates to other restaurant bills which the wife stated were for recruiting and training hostesses working under her. Once again we find the evidence of the wife unsatisfactory. The wife said that it was necessary for her to take hostesses to restaurants to recruit them. This we do not accept as being a true statement but even if it were true we were not given any particulars with regard to which hostess was

recruited where, when or why. Likewise with regard to training, we do not know the nature of the training and would have thought that it was much more appropriate to train the hostesses at the place of work. It would seem inappropriate to train them in the course of eating a meal. The eating of a meal would appear to have nothing to do with the training. It was suggested by the wife that no other place was suitable. This we do not accept. Once again we have no evidence from the night club with regard to the procedures for training employees. We have no knowledge of what sort of training or instruction was supposed to have been taken place during these meal sessions in restaurants. Here again we reject the claim by the Taxpayer.

Earlier in this decision we have made reference to the meaning of the words 'in the production of the assessable income' as they appear in section 12(1)(a) of the Inland Revenue Ordinance. It appears to us that some of the expenses claimed by the Taxpayer might possibly be categorised as being incurred for the purpose of producing the assessable income but definitely not incurred in its production.

In the Commissioner's determination, the Commissioner decided that he would permit the assessment to be revised in accordance with a concession proposed by the assessor to allow a deduction of 10% from the taxable income of the wife. Apparently it was the practice of the Inland Revenue Department in assessing such cases to allow a percentage of the commission income to cover such allowable outgoings and expenses as might have been incurred in earning commission income. We pointed out to the representative for the Taxpayer in the course of the hearing that having heard all of the evidence regarding all of the deductions claimed by the Taxpayer we would make a decision on the evidence and the facts before us which would be precise and we would not be able then to agree to permit a percentage deduction by way of concession or to accord with any Inland Revenue Department practice. This was understood by the representative for the Taxpayer. The hearing of this case extended over three half day sessions during which the representative for the Taxpayer and the wife in her evidence produced and referred to over a hundred vouchers which totalled $76,992. As the Board has now been through in great detail all of the expenses claimed as deductions by the Taxpayer and has rejected the same, it is clear that this Board cannot then decide that the Taxpayer should be allowed a concession of a 10% deduction from the taxable emoluments. The Taxpayer has had the opportunity of providing his entire claim item by item and by attempting to do so has rejected the opportunity to benefit from any concession afforded by a departmental practice. Accordingly we find in favour of the Commissioner, dismiss this appeal and order that the salaries tax assessment for the year of assessment 1987/88 dated 9 December 1988 showing assessable income of $283,499 with tax payable thereon of $46,700.77 is affirmed and that that part of the Commissioner's determination which ordered the assessment to be reduced be overruled.