# Case No. D82/02

**Profits tax** – whether certain sums are deductible as outgoings and expenses under section 16(1) – mere compliance with section 16(1) is not sufficient, it must also not be excluded under section 17(1) – whether the transaction was 'artificial or fictitious' – any contemporaneous document in support – must show he did incur liability for rental in respect of such user and the amounts claimed were attributable to the liabilities which he so incurred – burden of proof on the appellant – sections 14, 16, 17, 61 and 68(4) of the Inland Revenue Ordinance ('IRO').

Panel: Ronny Wong Fook Hum SC (chairman), Gidget Lun Kit Chi and Agnes Ng Ka Yin.

Date of hearing: 28 September 2002.
Date of decision: 11 November 2002.

The appellant sought to deduct from the profits of Company A, a company registered by the appellant for carrying out his computer engineering business, various sums which he allegedly incurred as rental in respect of Properties 1, 2, 3 and another piece of property at Address H. Properties 1, 2 and 3 were acquired by Company C in which the appellant was appointed as one of its directors.

The facts appear sufficiently in the judgment.

**Held:**

1. Sections 16 and 17 provided for the deductions to be permitted or excluded for profits tax purposes.

2. Section 61 provided for the situation in which the Revenue could refuse deduction if the transaction was 'artificial or fictitious'.

3. Section 68(4) put the burden of proof that the assessment appealed against is excessive or incorrect on the appellant.

4. The initial hurdle which the appellant had to surmount was to demonstrate to the Board that Company A did incur rental to the extent claimed. The Board was not satisfied on a balance of probabilities that any such rental was incurred by Company A in respect of any of the four premises.

5. It was insufficient for the appellant to aver that he did utilize each of the four premises for the purposes of Company A. What he had to demonstrate was that he did incur liability for rental in respect of such user and the amounts claimed were attributable to the liabilities which he so incurred as opposed to what he regarded as appropriate for the purpose of reducing his fiscal responsibility.

6. The appellant failed at the initial hurdle. It was unnecessary for the Board to express any view on the additional arguments of the Revenue on the basis of Fahy v CIR 3 HKTC 695 and section 61 of the IRO.

**Appeal dismissed.**

Case referred to:

Fahy v CIR 3 HKTC 695

Chow Chee Leung for the Commissioner of Inland Revenue.
Taxpayer in person.

**Decision:**

**Background**

1. On 23 December 1990, the Appellant registered a business in the name of Company A. At all material times, the Appellant declared in his tax returns that Company A carried on a computer engineering business at Address B ('the Office'). The Appellant claimed and the Revenue accepted deductions in respect of rent incurred by Company A for use of the Office.

2. Company C is a company incorporated in Hong Kong on 18 May 1993. The Appellant and one Madam D were appointed directors of Company C on 4 June 1993. Madam D resigned as director of Company C on 26 June 1996. The Appellant's wife was appointed director on the same day.

3. Company C acquired the following pieces of properties:

(a) A flat at Housing Estate E ('Property 1'). This was purchased by Company C on 28 June 1993 for $2,470,000 and sold by Company C on 15 July 1996 for $2,920,000.

(b) A flat at Housing Estate F ('Property 2'). This was purchased by Company C on 24 June 1996 for $5,580,000 and sold by Company C on 21 April 1999 for $4,250,000.

(c) A flat at Housing Estate G ('Property 3'). This was purchased by Company C on 27 April 1999 for $5,550,000. It is still held by Company C.

4. The Appellant seeks to deduct from the profits of Company A various sums which he allegedly incurred as rental in respect of Properties 1, 2, 3 and another piece of property at Address H (' the Showroom' ).

**The claims**

5. In respect of Property 1

(a) The total usable area of this flat is 500 square feet. The Appellant says that it was used as his workshop and as the bedroom for him and his wife.

(b) The Appellant seeks to deduct from the profit of Company A rent in the sum of $240,000 for the period between 1 April 1994 and 31 March 1995 and in the further sum of $240,000 for the period between 1 April 1995 and 31 March 1996 allegedly for use of this flat.

(c) The Appellant accepts that he did not enter into any tenancy agreement with Company C regulating his occupation of this property.

6. In respect of Property 2

(a) The total usable area of this flat is 730 square feet. The Appellant says that he used it as his workshop and bedroom.

(b) The Appellant seeks to deduct from the profit of Company A rent in the sum of $70,000 for the period between 1 April 1999 and 31 May 1999 allegedly for use of this flat.

(c) The Appellant accepts that he did not enter into any tenancy agreement with Company C regulating his occupation of this property.

(d) The Appellant relies on a deposit entry of $100,000 in the Bank I account of Company C on 4 August 1999 as supportive of the rental that Company A allegedly paid to Company C for use of this flat.

7. In respect of Property 3

(a) The total usable area of this flat is 840 square feet. The Appellant says that he used it as his workshop and bedroom. Prior to 16 December 2000, only he and his wife occupied this property. They were joined by their son after 16 December 2000 and he ceased using this flat for business purpose thereafter.

(b) The Appellant seeks to deduct from the profit of Company A rent in the sum of $350,000 for the period between 1 June 1999 and 31 March 2000 allegedly for use of this flat.

(c) The Appellant accepts that he did not enter into any tenancy agreement with Company C regulating his occupation of this property.

(d) The Appellant relies on another deposit entry of $100,000 in the Bank I account of Company C on 15 October 1999 as supportive of the rental that Company A allegedly paid to Company C for use of this flat.

8. In respect of the Showroom

(a) By a tenancy agreement dated 16 February 1993, the owner of this property let the same to Company J for two years commencing from 20 January 1994 at a rent of $23,609 per month. Under this tenancy agreement, Company J was prohibited from subletting it to another person.

(b) The Appellant seeks to deduct from the profit of Company A rent in the sum of $160,000 for the period between 1 April 1994 and 31 March 1995 and in the further sum of $60,000 for the period between 1 April 1995 and 31 March 1996 allegedly for use of this showroom.

(c) The Appellant asserts that Company J subletted one third of the Showroom to him with rental at $40,000 per quarter. The Appellant further asserts that rental was paid partly in cash and partly in kind via the provision of computer network management service.

(d) The Appellant accepts that there is no written tenancy agreement between Company A and Company J. He relies on four receipts allegedly issued by Company J dated 30 April 1994, 30 July 1994, 31 October 1994 and 31 January 1995 each for $40,000 allegedly in payment of ‘Office rental & showroom’.

**Relevant statutory provisions**

9. Section 16(1) of the IRO provides that:

> *' In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period, including –*
>
> *...*
>
> *(b) rent paid by any tenant of land or buildings occupied by him for the purpose of producing such profits ...' .*

10. Section 17(1) of the IRO provides that:

> *' For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of –*
>
> *(a) domestic or private expenses, ...*
>
> *...*
>
> *(f) rent of ... any premises ... not occupied or used for the purpose of producing such profits' .*

11. Section 61 of the IRO provides that:

> *' Where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessed accordingly.'*

12. Section 68(4) of the IRO provides that:

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

**Our decision**

13. The initial hurdle which the Appellant has to surmount is to demonstrate to us that Company A did incur rental to the extent claimed. We are not satisfied on a balance of probabilities that any such rental was incurred by Company A in respect of any of the four premises.

14. In respect of Properties 1, 2 and 3:

(a) no tenancy agreement was executed between Company A and Company C;

(b) there is no primary evidence indicating payment of any rent by Company A to Company C let alone rent to the extent claimed;

(c) the two entries of $100,000 in Company C's passbook with Bank I are equivocal. There is nothing to suggest that those were in fact payments effected by Company A in respect of its occupation of Property 2 or Property 3.

15. In respect of the Showroom:

(a) there is no evidence indicating actual use of the Showroom by the Appellant;

(b) no tenancy agreement was executed between Company J and Company A. The head lease of Company J prohibited the grant of any sub-tenancy;

(c) the Appellant adduced no primary evidence indicating withdrawal of cash in payment of Company J;

(d) we were given no explanation as to the type of computer network management service rendered in favour of Company J.

16. It is insufficient for the Appellant to aver that he did utilise each of the four premises for the purposes of Company A. What he has to demonstrate is that he did incur liability for rental in respect of such user and the amounts claimed are attributable to the liabilities which he so incurred as opposed to what he regards as appropriate for the purpose of reducing his fiscal responsibility.

17. The Appellant fails at the initial hurdle. It is unnecessary for us to express any view on the additional arguments of the Revenue on the basis of Fahy v CIR 3 HKTC 695 and section 61 of the IRO.

18. We dismiss the Appellant's appeal.