INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D91/03

Salaries tax – section 12(1) of the Inland Revenue Ordinance ('IRO') - whether or not professional indemnity insurance is incurred in the production of assessable income - whether or not the professional indemnity insurance is a deductible expense of a qualified solicitor.

Panel: Ronny Wong Fook Hum SC (chairman), Susan Beatrice Johnson and James Wardell.

Date of hearing: 6 November 2003.
Date of decision: 20 January 2004.

The appellant is a qualified solicitor. The appellant claimed deduction against salaried income in respect of professional indemnity insurance. The issue is whether the appellant is entitled to such deduction from her income.

Held:

The Board is of the view that the sum in question was not 'incurred in the production of the assessable income'. The sum was incurred so as to put the appellant in a position to earn the income. It was a sum incurred so as to qualify the appellant to perform the duties of her office as a solicitor. The sum was not incurred in the course of the appellant earning her income (Lomax v Newton 34 TC 558, Brown v Bullock 40 TC 1, Humbles v Brooks 40 TC 500, CIR v Robert Burns 1 HKTC 1181, Lunney v Commissioner of Taxation (1957) 100 CLR 478 and Commissioner of Inland Revenue v Sin Chun Wah 2 HKTC 364 considered).

Appeal dismissed.

Cases referred to:

Lomax v Newton 34 TC 558
Brown v Bullock 40 TC 1
Humbles v Brooks 40 TC 500
CIR v Robert Burns 1 HKTC 1181
Lunney v Commissioner of Taxation (1957) 100 CLR 478
Commissioner of Inland Revenue v Sin Chun Wah 2 HKTC 364

Tang Hing Kwan for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

Background facts as found by us

1. The Appellant is a qualified solicitor. She commenced employment with the Solicitors' Firm as from 2 May 2001.

2. The Solicitors' Firm submitted to the Revenue an employer's return of remuneration and pensions for the year ended 31 March 2002 in respect of the Appellant showing, inter alia, the following particulars:

Period of employment	:	2-5-2001 – 31-3-2002
Capacity employed	:	Consultant
Income		
Commission/fees	:	$133,336

3. In her Tax Return – Individuals for the year of assessment 2001/02, the Appellant declared the same amounts of income as returned by the Solicitors' Firm. Against the salaried income, the Appellant claimed deduction in respect of various expenses including a sum of $10,766 in respect of professional indemnity insurance.

4. In support of her claim, the Appellant submitted a letter from the Solicitors' Firm dated 21 January 2003 wherein the Solicitors' Firm stated that:

> *'We do hereby confirm that it is pre-requisite and part of the employment terms for [the Appellant] to hold membership and Practising Certificate with the Law Society of Hong Kong together with paying her share of the insurance premium'.*

5. In further support of her claim, the Appellant submitted a bundle of receipts issued by the Solicitors' Firm as follows:

Date of receipt	**Amount**	**Purpose**
5-12-2001	$211.2	Professional Indemnity Scheme Fee Insurance of

		November 2001
4-1-2002	$258.72	Professional Indemnity Scheme Fee Insurance of December 2001
7-2-2002	$282.08	Insurance Insurance of January 2002
7-2-2002	$9,750	Insurance Professional insurance from 1-10-2001 –30-6-2002
12-3-2002	$118.8	Insurance Insurance of February 2002
11-4-2002	$145.2	Insurance Insurance of March 2002
	$10,766	

6. The issue before us is whether the Appellant is entitled to deduct the sum of $10,766 from her income for the year 2001/02.

Professional indemnity in respect of a solicitor

7. Section 7 of the Legal Practitioners Ordinance (Chapter 159) provides that:

'No person shall be qualified to act as a solicitor unless –

(a) ...

(b) ...

(c) ...

(d) he is complying with any indemnity rules made by the Council under section 73A that apply to him ...'.

8. Section 73A(1) of the Legal Practitioners Ordinance provides that:

'The Council may make rules (in this Ordinance referred to as "indemnity rules") concerning indemnity against loss arising from claims in respect of any description of civil liability incurred –

(a) by a solicitor ... in connection with his practice ...

(b) by an employee of a solicitor ... in connection with that solicitor's practice...'.

9. Rule 6(1) of the Solicitors (Professional Indemnity) Rules provides that:

' Subject to rule 7, every solicitor who is ... a solicitor in Practice in Hong Kong shall be required to have and maintain Indemnity'.

10. Rule 4 and the First Schedule of the Solicitors (Professional Indemnity) Rules regulates the amount which every principal in Practice is obligated to contribute towards the indemnity fund as established and maintained by the Law Society in respect of himself and of all assistant solicitors and consultants in his firm. The amount of contribution is calculated by reference to two components. The first component is the number of principals, assistant solicitors and consultants in the firm. The second component is the gross fee income of the firm.

Case of the Appellant

11. When the case was considered by the Commissioner and when the matter was first argued before us on 6 November 2003, there was no dispute that the Appellant did receive commission in the sum of $133,336 from the Solicitors' Firm and did reimburse the Solicitors' Firm the sum of $10,766 in respect of professional indemnity insurance as summarised in paragraph 5 above. In her written submission submitted after conclusion of the hearing before us, the Appellant asserted that her agreement with the Solicitors' Firm was that 'her earnings shall be **net** of the 50% of the Gross Fee Income received by the Employer on files solicited and handled by the Appellant, **after** deducting therefrom her share of the [professional indemnity insurance] paid by the Employer in respect of BOTH her head count (HK$13,000 per Solicitor for 2001/2002) and a % count on Gross Fee Income (2.64% for 2001/2002), when the Gross Fee Income of the Firm does not exceed HK$5 million) ...'. She further explained that it was for 'simplicity and clarity purpose' that both the Employer's Return and the Individual Tax Return shall report the 50% Gross Fee Income *before* the deduction of the professional indemnity insurance.

12. We are not prepared to consider the new case of the Appellant as postulated in her written submission tendered after conclusion of the hearing before us. It is wholly contrary to the previous stance of the Solicitors' Firm and the Appellant. The new case is also totally inconsistent with the receipts which we summarised in paragraph 5 above. Bearing in mind the profession of the Appellant, we are not prepared to entertain her suggestion that her fiscal position should be considered on the basis that she was in fact carrying on a business or that she only received from the Solicitors' Firm a net sum after deducting professional indemnity insurance.

The relevant provisions in the Inland Revenue Ordinance (Chapter 112) ['IRO'] and the authorities in relation thereto

13. Section 12(1) of the IRO provides that:

> *'In ascertaining the net assessable income of a person for any year of assessment, there shall be deducted from the assessable income of that person –*
>
> *(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.'*

14. In Lomax v Newton 34 TC 558, Vaisey J. explained the parallel English provisions in these terms:

> *'... I would observe that the provisions of that Rule are notoriously rigid, narrow and restricted in their operation. In order to satisfy the terms of the Rule it must be shewn that the expenditure incurred was not only necessarily but wholly and exclusively incurred in the performance of the relevant official duties ... An expenditure may be "necessarily" for the holder of an office without being necessary to him in the performance of the duties of that office; it may be necessary in the performance of those duties without being exclusively referable to those duties; it may perhaps be both necessarily and exclusively, but still not wholly so referable. The words are indeed stringent and exacting; compliance with each and every one of them is obligatory if the benefit of the Rule is to be claimed successfully. They are, to my mind, deceptive words in the sense that when examined they are found to come to nearly nothing at all'.*

15. Lomax v Newton was followed in Brown v Bullock 40 TC 1. Donovan LJ propounded the well known statement of principle in these terms:

> *'The test is not whether the employer imposes the expense but whether the duties do, in the sense that, irrespective of what the employer may prescribe, the duties cannot be performed without incurring the particular outlay'.*

16. The position was further amplified by Ungoed-Thomas J in Humbles v Brooks 40 TC 500 at page 502

> *'"In the performance of the said duties" means in the course of their performance ... It means "in doing the work of the office, in doing the things which it is his duty to do while doing the work of the office. It does not include qualifying initially to perform the duties of the office, or even keeping qualified to perform them ... it does not mean adding to the taxpayer's usefulness in*

> *performing his duties. The requirement of the employer that the expenditure shall be incurred does not, of itself, bring the expense within the Rule, nor does the absence of such a requirement exclude it from the application of the Rule...'.*

17. The words 'in the production of the assessable income' in section 12(1)(a) of the IRO was considered by the Court of Appeal in CIR v Robert Burns 1 HKTC 1181. The taxpayer was a racehorse trainer employed by the Royal Hong Kong Jockey Club. He sought to deduct from his assessable income for salaries tax purposes legal expenses which he incurred in successfully overturning a six months disqualification imposed on him by the Club. Huggins JA considered without dissent the following submission on behalf of the Commissioner:

> *'The substance of the argument on behalf of the Commissioner is that the Board of Review misdirected itself when it considered whether the appeal was necessary "for" the production of the assessable income. As I understand it, the contention is that, having held that the appeal was necessary for the production of the income, the Board proceeded to conclude that the expenditure on legal fees was therefore incurred in the production of that income. Mr Barlow submits that this was a non sequitur and that although the expenses were incurred in order to place the Respondent in a position in which he was able to earn part of the assessable income they were not incurred in the production of it. He points out that the removal of the disqualification upon the appeal did not make the Respondent as much as one cent richer, but it did enable him to continue training horses and thus to earn further salary'.*

At page 1190 Huggins JA further considered the following statement of McTiernan J in Lunney v Commissioner of Taxation (1957) 100 CLR 478:

> *' In my opinion it is an unduly narrow construction of the initial part of section 51(1), in the case of employment, to confine its operation to expenditure made by the taxpayer within the bare physical or temporal limits within which he performs his work or labour and to disregard any expenditure made outside those limits even though it has a necessary relation to the purpose of earning income for which the taxpayer carries on the employment'.*

Huggins JA commented as follows:

> *' That is an approach which has much to be said for it, but I think the weight of authority is against it'.*

18. The authorities were received by Nazareth J (as he then was) in Commissioner of Inland Revenue v Sin Chun Wah 2 HKTC 364. The taxpayer in that case sought to deduct one

month's wages which he paid to his former employer in lieu of notice in order to enable him to commence employment with his new employer. His Lordship concluded at page 372 that the authorities draw a distinction between expenditure for the purpose of the production of assessable income and expenditure in gaining or for the production of assessment income. His Lordship explained at page 370 that whether or not an expenditure is incurred in or in the course of producting one's income '*... depends upon considerations which are concerned more with the essential character of the expenditure itself than with the fact that unless it is incurred an employee or a person pursuing a professional practice will not even begin to engage in these activities from which their respective incomes are derived'*. He rejected the claim of the taxpayer as the sum in question was made for the purpose of the new employment and not in the production of the assessable income.

Our decision

19. We are of the view that the sum in question was not 'incurred in the production of the assessable income'. The sum was incurred so as to put the Appellant in a position to earn the income. It was a sum incurred so as to qualify the Appellant to perform the duties of her office as a solicitor. The sum was not incurred in the course of the Appellant earning her income.

20. For these reasons, we dismiss the Appellant's appeal.