INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D91/89

Profits tax – whether taxpayer is a club within the meaning of section 24(1) of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Hwang King Hung and Patrick Wu Po Kong.

Date of hearing: 9 November 1989.
Date of decision: 11 January 1990.

The taxpayer was formed as a company limited by guarantee by a small group of individuals who were its promoters. The purpose of the taxpayer was to be a snooker club for the benefit of its members and their friends. The taxpayer entered into an agreement with another company owned and controlled by the same promoters which company provided management and all services to the taxpayer. For the Commissioner it was submitted that the taxpayer was in effect a sham and that section 24(1) of the Inland Revenue Ordinance had no application.

Held:

The taxpayer was a legal entity carrying on a club and qualified under section 24(1) of the Inland Revenue Ordinance.

Appeal allowed.

H Bale for the Commissioner of Inland Revenue.
Lau Kam Cheuk of S Y Leung & Co for the taxpayer.

Decision:

This is an appeal by a limited company incorporated by guarantee against a determination by the Deputy Commissioner that the company was not a club within the meaning of the Inland Revenue Ordinance.

The facts are as follows:

1. The Taxpayer was incorporated as a company limited by guarantee and not having a share capital in Hong Kong in 1985. Its objects of association

included the establishment, maintenance and conduct of a club for the benefit of members of the Taxpayer and their friends. Its articles of association adopted the articles set out in table C to the Companies Ordinance with certain amendments in the following form:

'Preliminary

1 The regulations contained in the articles of association in table "C" in the first schedule to the Companies Ordinance (Chapter 32) shall apply to the company save in so far as they are hereby expressly excluded or modified. In case of conflict between the provisions of table "C" and these present, the provisions herein contained shall prevail.

Members

2. The number of members with which the company proposes to be registered is unlimited.

3. The members of the company shall be divided into two classes, namely, members and honorary members.

4. An honorary member shall be entitled to the ordinary privileges of membership except the right to attend and vote at any general meeting, and he shall not be entitled to any dividend bonus or distribution of any surplus, profit or asset of the company.

5. The directors shall have absolute discretion as to the admission of applicant to any class of membership of the company.

Bye-laws

6. The directors shall have power to make bye-laws and any bye-laws may be annulled or varied by the directors.

7. All bye-laws so made and for the time being in force shall be binding on all classes of members and have full effect accordingly.

8. No bye-law made by the directors shall operate so as to abrogate, modify or vary any provisions contained in the memorandum of association or these presents, and in case of any conflict or inconsistency between any bye-law so made as aforesaid and the memorandum of association or these presents such bye-laws shall be inoperative and void to the extent of such conflict or inconsistency.'

2. In its 1985/86 profits tax return, the Taxpayer described the nature of its business as 'club runner' and stated that its income was not subject to profits tax. The Taxpayer's accounts for the period from 25 October 1985 to 31 March 1986 stated that the only source of income was 'membership fee' received.

3. The assessor did not accept the Taxpayer's claim that it should be exempted from tax and on 6 March 1987 he raised a profits tax assessment for the year of assessment 1985/86 on the Taxpayer assessing the net membership fees received of $19,552 to tax of $3,617.

4. By letter dated 11 March 1987 the tax representative for the Taxpayer objected to the assessment on the ground that the Taxpayer is exempted from profits tax under section 24(1) of the Inland Revenue Ordinance.

5. The reason for the incorporation of the Taxpayer was to enable it to establish a snooker club for the benefit of its members and their friends. The promoters of the Taxpayer were a small group of individuals who wished to establish and run a snooker club for profit. Two of the promoters were the two subscribers to the memorandum and articles of association. The modus operandi was for the promoters to incorporate a company, namely the Taxpayer, in the form of a club, and cause it to enter into an agreement with another company ('the management company') which was owned and controlled by themselves and which agreement appointed the management company to be the manager and required the management company to provide all of the snooker and club facilities. In other words the Taxpayer sub-contracted at no expense to itself the entire management and operation of all of its facilities to another profit-making company which was owned and controlled by the original promoters of the Taxpayer.

6. The management agreement referred to under the preceding fact was for an indefinite period of time and provided that the management company would pay to the Taxpayer a sum of not less than $1 per calendar year for the rights and obligations granted by the Taxpayer to the management company.

7. The establishment of the club premises where the Taxpayer had its club was undertaken by the management company, and the provision of all of the snooker and other equipment were owned by and provided by the management company for the use and enjoyment of the members of the Taxpayer.

8. Membership of the Taxpayer was offered to members of the public in Hong Kong who were prepared to pay an annual membership fee of $10 to the Taxpayer. A membership register of the Taxpayer was maintained in which was entered the names of all of the persons who completed a rudimentary membership application form, who paid the fee of $10 and were admitted to membership. When the Taxpayer was incorporated, it was incorporated

without limit as to the number of members who could be admitted to membership and during the period of its operation a few thousands of persons were admitted to membership of the Taxpayer.

9. In addition to the members who paid $10 membership fee, a small number of honorary members were admitted. Members had full rights of membership including voting rights. Honorary members paid no membership fee and had no voting rights.

10. The handling of the corporate affairs of the Taxpayer left much to be desired. The promoters appointed themselves or purported to appoint themselves to be the directors of the Taxpayer. They purported to convene and hold an annual general meeting of the members of the Taxpayer but from the evidence before the Board it is clear that the purported annual general meeting was a total nullity because no proper notice was given to the members. Furthermore it would appear that the promoters were not registered in the register of members as being members of the Taxpayer and had little or no regard for the legal niceties of operating and running a company limited by guarantee according to the provisions of the Companies Ordinance. However it would also appear that the members of the Taxpayer were in no way concerned regarding the failure by the promoters properly to run the corporate affairs of their company and they themselves had no interest in running such corporate affairs on their own behalf.

At the hearing of the appeal the tax representative for the Taxpayer appeared and submitted that the Taxpayer had 3,943 members who each paid a membership fee of $10 thereby contributing a total of $39,430 for the year ended 31 March 1986. He pointed out that only those who paid the membership fee were members entitled to vote and that the small number of honorary members who paid no membership fee were not entitled to any voting rights. He submitted that the purported annual general meeting had been validly convened because it was not practical to give notice to all of the members individually and therefore the directors had decided simply to post a notice on the notice board at the club premises. As we have found in the facts set out above the purported annual general meeting was a nullity and with due respect to the tax representative his submissions in this regard are erroneous. The articles of association of the Taxpayer require notice to be given to each member and this was not done. A purported notice posted on the notice board at the club premises is of no legal effect.

The tax representative went on to draw our attention to section 24 of the Inland Revenue Ordinance and submitted that within the meaning of section 24 the Taxpayer was a club and as all of its income comprised subscriptions from its members it was deemed not to carry on business and accordingly not to be taxable.

The representative for the Commissioner submitted in effect that the Taxpayer was a sham and that it did not qualify as a club within the meaning of section 24 of the

Inland Revenue Ordinance. The representative for the Commissioner submitted that all of the members of the Taxpayer were not entitled to vote within the meaning of section 24(3) and therefore section 24(1) had no application. He submitted that the onus of proof was upon the Taxpayer and that the Taxpayer had called no witnesses, directors, club members or the auditor to give evidence. He submitted that he had no opportunity to cross-examine any witness because none had been called and further submitted that the onus of proof is a heavy one. He drew our attention to many alleged irregularities in the conduct of the affairs of the Taxpayer and in particular in relation to the purported annual general meeting and the appointment or purported appointment of the original promoters to be the directors of the Taxpayer whose names did not appear in the membership list.

The representative for the Commissioner pointed out that the four directors of the management company were the same persons who were the four purported directors of the Taxpayer and he challenged the reason why the Taxpayer would appoint a management company to manage its affairs when the management company and the Taxpayer both had the same four identical directors. He pointed out that under the agreement between the Taxpayer and the management company the Taxpayer had granted to the management company all of the snooker club operation rights for the sum of $1 per annum. He submitted that the Taxpayer and the management company were not at arm's length. He went on to submit that when subsequently the Taxpayer ceased operations its assets in the form of the net cash received from membership fees, which should have belonged to the members, were paid over to the management company in the form of rent and fees. By this means the assets of the Taxpayer were made to equal zero and therefore no distribution of surplus funds had to be made to the members.

With due respect to the Commissioner's representative we are not able to agree with what he submitted and find in favour of the Taxpayer.

The essence of the Commissioner's case is to ask us to disregard the facts as we have found them and to hold that the Taxpayer is not a club within the meaning of section 24(1) of the Inland Revenue Ordinance. With due respect we do not understand the reason for this point of view nor what the Commissioner appears to be seeking to achieve in this case.

It seems that the reason for the creation of the Taxpayer was to comply with some form of licencing requirements relating to the operation of snooker establishments. Whatever these requirements may have been is no concern of us in deciding this appeal. All that concerns us is that the promoters of the club decided, for reasons best known to themselves, that they would conduct their business on the basis of forming a company limited by guarantee and having no share capital. This company was used solely for the purpose of admitting members into a defined group who were then entitled to use the snooker club facilities which the promoters provided at no expense to the Taxpayer through the management company. No doubt the promoters set up this corporate structure with a view to their ultimately making profits for themselves. However this does not mean that the arrangement was a sham. It was a genuine legitimate and legally established structure

which they were entitled to use. What we must do is to look at this de facto legal structure and decide what are its tax implications. The Commissioner's representative invited us to accept that the members of the Taxpayer were not true members because of the way in which the affairs of the Taxpayer were operated. However we cannot go so far as to say that the Taxpayer did not exist or that its affairs were not a reality. The facts before us are that members of the public were admitted to become members of the Taxpayer. They submitted an application form for membership and paid a membership fee of $10 each. The application form for membership may have been scanty in its content but it was a sufficient document to enable the members to be identified and for their names to be recorded in a membership register. A membership register was maintained and the names of the members were entered into the membership register. We have no doubt that these formalities were required for reasons totally different from the Inland Revenue Ordinance . Presumably they were maintained as part of the requirements of the snooker hall licencing system which the promoters had adopted but this is not material for us to consider. Based on the facts we cannot say that the Taxpayer did not exist or that it did not have members.

The articles of association of the Taxpayer were in the form of the standard table C contained in the first schedule to the Companies Ordinance. Table C of the Companies Ordinance provides that the first directors of a company shall be appointed by the subscribers to the memorandum of association. It does not state that directors must be members of the club. The case for the Commissioner was not based on any allegation that the four promoters were not the directors of the Taxpayer but that there were a number of irregularities, for example, the names of the directors did not appear in the membership list.

The only income of the Taxpayer was membership fees received from its members. The quantum of the membership fees was very small and the gross receipts of the Taxpayer were likewise small. We do not understand why the Commissioner should be so insistent on attempting to show that the Taxpayer was a sham in such circumstances. Furthermore we do not understand the submission made by the Commissioner's representative that the surplus monies representing the net subscriptions received by the Taxpayer were subsequently paid over to the management company and not distributed to the members. It is not for us, or indeed the Commissioner, to attempt to investigate the affairs of this or any other company. This is the function of other Government officers and courts. Indeed in the absence of allegations of fraud there would appear to be no reason why the surplus monies belonging to the Taxpayer could not be paid by way of fees to the management company which appears to have had the responsibility for looking after the affairs of the Taxpayer. If this had not been done the members might have been called upon to make additional contributions to the Taxpayer to enable its affairs to be closed down. However this is not for us to investigate or speculate. The fact is that the monies were paid by the Taxpayer to the management company and no doubt have been or should have been included in the income of the management company and would be subject to tax as being profits of the management company.

We also do not understand the submission made by the Commissioner's representative that the members were not entitled to vote at general meetings of the

Taxpayer because the annual general meeting was improperly convened. It is a novel legal proposition that if the directors of a company fail in their obligations to manage the affairs of a company properly, they thereby remove or confiscate the voting rights of the members of the company. As we mentioned to the Commissioner's representative, if this were the law then no doubt many unscrupulous individuals would take the opportunity of cancelling members' voting rights by using the simple device of omitting to send them notice of general meetings in accordance with the articles of association.

The Commissioner's representative also challenged whether or not the Taxpayer was carrying on a club. In this regard we again find no substance in the representative's submission. There are many ways whereby a company can carry on a club. A well recognised method is to sub-contract the day-to-day running and management of the club to a third party. In the present case the Taxpayer for a nominal fee of not less than $1 has sub-contracted to the management company all rights and obligations in relation to the operation and running of the club facilities. The employment of an agent for this purpose does not mean that the Taxpayer was not carrying on the club. The submission that the board of directors of the Taxpayer and of the management company were one and the same persons and therefore there was no need for the Taxpayer to employ the management company is also of no substance. There are many ways that a company can carry on activities. It is frequently the case that for many and diverse reasons a company which is a legal person will employ the services of another company to do what the first company could have done for itself. Again it is not for us to speculate what could or could not have been done. All we are required and bound to do is to look at the actual facts before us without speculation.

We have found as a fact that the Taxpayer had a number of members and that under the articles of association these members were entitled to voting rights. We have also decided that the Taxpayer was carrying on a club. Accordingly under the provisions of section 24(1) and (3) of the Inland Revenue Ordinance the Taxpayer was a company which was carrying on a club and which received from its members not less than half of its gross receipts on revenue account and is deemed not to have been carrying on a business.

For the reasons given we allow this appeal and order that the assessment appealed against be annulled.