INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D94/99

Profits Tax – consultancy fee – recipient company almost wholly owned by the taxpayer – whether deductible expense – artificial arrangements – section 61 of the Inland Revenue Ordinance (the ' IRO').

Panel: Audrey Eu Yuet Mee SC (chairman), Kenneth Ku Shu Kay and John Lee Luen Wai.

Date of hearing: 2 November 1999.
Date of decision: 16 November 1999.

Mr B was the sole proprietor of Company A, the taxpayer which provided accounting and tax consultancy services. Company D was a limited company almost wholly owned by Mr B. Following a consultancy agreement, Company D provided consultancy services to matters referred to it by the taxpayer and the taxpayer paid a consultancy service fee of $1,391,200 to Company D for the year of assessment 1994/95. The taxpayer claimed that the service fee was a deductible expense.

Held:

Mr B did not give evidence and there is no evidence how the service fee came to be arrived at. The question whether the payment is a deductible expense in law must be answered objectively. There is no explanation as to how the service fee came to be increased from $12,000 every month to $1,391,200 for the relevant period (Salomon v A Salomon & Co Ltd, CIR v Howe, Copeman v William Flood & Sons Ltd, Earlspring Properties Ltd v Guest considered).

The taxpayer failed to discharge his onus.

Obiter:

The Board thinks that section 61 of the IRO is meant to catch the present situations, i.e., artificial arrangements whereby a taxpayer interposes a company in between himself and his own business for the deduction of his personal expenses which are otherwise not deductible from his business (D110/98 considered).

Appeal dismissed.

Cases referred to:

Salmon v A Salomon & Co Ltd [1897] AC 22
CIR v Howe [1977] 1 HKTC 936
Copeman v William Flood & Sons Ltd 24 TC 53
Earlspring Properties Ltd v Guest [1993] STC 473
D110/98, IRBRD, vol 13, 553

Tse Yuk Yip for the Commissioner of Inland Revenue.
Taxpayer represented by its representative.

Decision:

The appeal

1. This is an appeal by Company A (' the Taxpayer') against the determination of the Commissioner of Inland Revenue dated 4 May 1999 in relation to the objection by the Taxpayer against the profits tax assessment for the year of assessment 1994/95. The issue is whether a service fee of $1,391,200 should be allowed as deductible expense of the Taxpayer.

2. Before going further, we would first dispose of a preliminary point. The notice of appeal dated 7 June 1999 was given outside the one month time limit set by section 66 of the Inland Revenue Ordinance. However the Taxpayer produced evidence to show that the sole proprietor Mr B was out of Hong Kong for part of that time. The Revenue has no objection to the Board granting an extension of time for the lodging of the notice of appeal. We do so accordingly.

The agreed facts

3. The following facts are not in dispute.

4. In 1971, Mr B was registered as the sole proprietor of the Taxpayer to provide accounting and tax consultancy services. From 1 January 1988 to 30 July 1994, the Taxpayer was a partnership with Mr B as the 85% partner and Mr C as the other 15% partner. Since 1 August 1994, Mr B became the sole proprietor again.

5. The service fee was paid to Company D. Company D was a company incorporated on 26 November 1971. At the relevant time, Mr B was a director and a majority shareholder of

Company D owning all but one of its 102 issued shares. The other director and shareholder was Company E.

The objection

6. Upon the Taxpayer's failure to file its profits tax return for the year of assessment 1994/95 within the stipulated time, the assessor raised an assessment pursuant to section 59(3) of the Inland Revenue Ordinance. The Taxpayer objected to this assessment on the ground that it was excessive. In support of his objection, the Taxpayer relied on a general ledger showing the payment of the service fee of $1,391,200 out of a total income of $2,300,796.22 in the relevant year. He claimed the service fee as a deductible expense.

7. The service fee was said to be paid pursuant to a consultancy agreement dated 1 April 1979 signed between the Taxpayer and Company D. In the consultancy agreement, the Taxpayer was described as 'the Company' and Company D as 'the Consultant'. It contains inter alia the following terms:

> The Company has requested the Consultant to place its services and in particular the services of its trained personnel and officers at the disposal of the Company in such matters as shall from time to time and hereafter be referred to it by the Company (provided that they are within the scope of its competence) which the Consultant then agreed to do on the terms herein set forth and which it is intended this Agreement shall formally record
>
> Clause 1: Consultancy appointment
>
> The Company hereby retains the services of the Consultant in the field of the provision of qualified accounting staff including certified public accountants, Hong Kong tax experts, United States income tax experts, company secretarial staff, qualified accountants and bookkeepers and other ancillary staff usually associated with an accounting practice (herein referred to as 'the field of this Agreement') and for such other related matters as the Consultant shall be willing to act, to advise the Company to the best of its ability in all problems, questions and investigations which the Company may refer to it or its opinion and recommendation during the life of this Agreement.
>
> Clause 3 : Outside assistance
>
> Where the Consultant considers that it is necessary to use the services of a third party whether for information or for the supply of goods or services it shall be entitled to do so.

Clause 4 : Expenses

The Consultant shall be entitled to be reimbursed in respect of any expenses incurred by the officers or employees of the Consultant including expenses of travel and subsistence in performance of its duties hereunder.

Clause 5 : Remuneration

The Company shall in respect of its and its officers' services hereunder pay the Consultant firstly a fee of $12,000 every month. If the Consultant for its own purposes shall require payment of its remuneration in respect of the gross fees at periods in excess of a month it shall be entitled to be paid at such intervals.

The correspondence

8. Following the objection, the Revenue sought further information from the Taxpayer. By a letter dated 3 April 1996 from the Revenue to the Taxpayer, the following questions were asked:

Service fee paid $1,391,200

1. Give the full name and address of each recipient, amount paid to each and the relationship of its shareholders and/or directors with the partners.

2. Describe in detail the services rendered by the recipient, the basis on which fees are to be paid, the period covered by the agreement, etc.

3. Explain why the services are required by you in order to produce the chargeable profits and why the amount of service fee paid should be accepted as being commercially realistic and deductible.

4. State the amount of expenditure on any remuneration or benefits provided by fee recipient company to the partners and/or their connected persons.

5. Forward a copy of the contract or agreement under which the services are provided.

6. Submit a computation showing how the fees charged by the service company was calculated.

7. Advise the mode of payment (that is, by cash, by cheque or by bank transfer), the date and amount of each payment with documentary evidence in support.

8. Forward copies of invoices, receipts and bank records in respect of the transactions between the service company and you.

9. Submit copies of the minutes of meetings recording the approval of the terms of the service company agreement and any subsequent amendment thereof.

10. Submit copies of accounts of the service company and its profit tax computation if available.

11. Advise whether you and the service company made up accounts to the same date. If not, explain why.

9. The Taxpayer provided the following answers by a letter dated 2 July 1996:

1. The service fee was paid to Company D.

2. Company D provides qualified professional accountants to the accounting practice of Company A.

3. In order for Company A to offer accounting services, the services of qualified accountants are required. The fee is agreed periodically between the two companies on an arm' s length basis and therefore is a commercially realistic amount.

4. The fee recipient company pays a salary and certain benefits on behalf of Mr B.

5. A copy of the contract for the services is enclosed.

6. The fees are determined periodically by the parties.

7. The fees are paid by cheque.

8. A copy of the cancelled cheques can be provided if this is necessary.

9. A copy of the minutes concerning the agreement is enclosed.

10. Please write to the service company for the requested information.

11. Ourselves and the service company make the accounts up to the same date.

10. Based on the additional information, the Revenue revised the assessable profits upwards in accordance with its Departmental Interpretation and Practice Notes (DIPN) No.24. It apportioned the expenses of the Taxpayer in accordance with an analysis which we attach hereto by way of Appendix A.

11. By a letter dated 6 August 1997 to the Revenue, the Taxpayer objected to the adjustment and argued as follows:

> Concerning the amount of management fees paid by Company A, the amount paid equals to about $750 per hour for each working hour. This is assuming there are 46 working weeks in a year and there are 40 working hours per week. This is a rate considerably below what a professionally qualified accountant is paid, especially one who has almost 30 years of experience in Hong Kong and considerably more experience in the professional accounting field worldwide. We should point out that Mr B is used by the Government as an expert witness and paid a minimum $2,300 per hour which equals to over $4,200,000 per year if he was to work exclusively as an expert witness for the Government.

12. By another letter dated 3 July 1998 from the Revenue to the Taxpayer, the following additional information was sought:

> Service fee paid $1,391,200
>
> (a) The agreement dated 1 April 1979 provided that the fee was $12,000 per month. I understand that this fee has been varied. Please therefore let me have copies of the correspondence, memorandum or other documents signed between your firm and Company D which detailed how the fees for the year of assessment 1994/95 was to be charged.
>
> (b) A schedule to show the following payment details:
>
> (i) the date(s) on which the fee was paid;
>
> (ii) the amount paid each time; and
>
> (iii) the form of payment [that is, whether by cheque, cash or other specified means].
>
> (c) A staff list to show:
>
> (i) the names of the persons provided by Company D to work for your firm;

(ii) their Hong Kong identity card numbers; and

(iii) their positions.

(d) Whether, in the year of assessment 1994/95, Company D has provided other services or equipment to your firm besides the provision of a staff. If yes, please give details of those.

13. There is a reply from the Taxpayer dated 13 July 1998, but it would appear from the Revenue's reply dated 10 August 1999 that this was received by the Revenue on 14 July 1999, after the determination of 4 May 1999. The Taxpayer provided the following additional information:

Service fee paid $1,391,200

a) We are enclosing herewith copies of directors' meeting held on 31 March 1995 regarding the management fee for the year ended 31 March 1995 to be paid by Company A to Company D.

b) We are enclosing herewith a schedule of the amounts totalling $1,391,200. We would point out that these accounts have been audited and certified by qualified Hong Kong certified public accountants.

c) The staff provided by Company D were as follows:

i) Mr B.

ii) HKID No.

iii) Qualified certified public accountant, member of various accounting societies.

14. The material part of the minutes of the directors' meeting held on 31 March 1995 was as follows:

Management fee

It was resolved that the management fee payable by Company A for the year ended 31 March 1995 be $1,300,000.

This is in accordance with Clause 5 of the consultancy agreement dated 1 April 1979.

15. We attach hereto as Appendix B the schedule which was provided by the Taxpayer with the letter said to be dated 13 July 1998.

The Taxpayer' s case

16. The Taxpayer Mr B represented himself at the hearing. It was explained to him that in accordance with section 68(4) of the Inland Revenue Ordinance, he had to persuade us that the assessment was excessive or incorrect. He would have to show us that the service fee, or any part thereof, was deductible expense pursuant to section 16 of the Inland Revenue Ordinance.

17. Mr B chose not to give evidence nor to call any witness. His submissions can be summarized as follows:

(1) Company D is a separate legal entity from its shareholders and from the Taxpayer. The corporate veil can only be lifted in 4 instances namely, agency, trust, alien enemy and fraud. Since none of the 4 situations applies in this case, the corporate veil should not be lifted. He referred us to the well known case of Salmon v A Salomon & Co Ltd [1987] AC 22 as well as extracts from Smart' s Hong Kong Company Law Cases, Materials and Comments.

(2) The transaction was not fictitious or artificial. Company D existed in law and the amounts paid to Company D were audited and independently verified. He relied on the case of CIR v Howe [1977] 1 HKTC 936 as to the meaning of fictitious or artificial. He said the transaction in this case was intended to be carried out and was carried out. A written agreement had been signed between the parties.

(3) The Revenue' s assessment as shown in Appendix A was arbitrary and varied from assessor to assessor. It was not for the Revenue to determine what a fair or reasonable fee should be. It was a matter between the parties concerned. Here Company D and the Taxpayer had, between them, agreed on the fair and reasonable fee. If he, Mr B, had spent all his time working for the Government as an expert witness, he would have been entitled to a fee of $4,000,000 which was much higher than the service fee in this case.

(4) The Commissioner had given verbal assurance that Practice Note No.24 was not meant to operate retrospectively. Since Practice Note No.24 was only issued in August 1995 and the relevant period was from April 1994 to March 1995, the Revenue could not rely on the Practice Note to make a retrospective assessment based thereon.

(5) Practice Note No.24 was not part of the law. The Revenue could not change the law by issuing Practice Notes.

(6) Service companies have been in use for years. They were set up by tax advisors as a preferred method for arranging one's tax liability. Mr B relied on several passages in decided cases to the effect that a taxpayer may take advantage of loopholes in the law to reduce his tax liability. Company D had been used for some 30 years and was accepted by the Revenue. There has been no change in the law on this aspect.

(7) The service fee should be considered as a whole and should not be broken down.

The Revenue's case

18. The Revenue relied on sections 16(1), 17(1) and 68(4), but not section 61 of the Inland Revenue Ordinance.

19. We were referred to Copeman v William Flood & Sons Ltd 24 TC 53 and Earlspring Properties Ltd v Guest [1993] STC 473 for the proposition that whether a sum was expended for the purpose of producing chargeable profits was to be tested objectively.

20. Miss Tse for the Revenue pointed out several discrepancies in the Taxpayer's case. For example, the minutes of the directors' meeting only refer to $1,300,000 and not $1,391,200. Further the minutes referred to 'management fee' and the audited accounts of Company D also refer to the provision of management services. Yet the services described in the consultancy agreement was the provision of qualified accounting staff. In the letter purportedly dated 13 July 1998, only Mr B's name was given as the staff in Company D who worked for the Taxpayer but the schedule attached as Appendix B showed two other names.

21. Miss Tse submitted that there was little information as to how the consultancy agreement was carried into effect. The schedule shown as Appendix B hereto did not show regular payments. There was no detail of the services rendered by Company D in return for the payments or the basis upon which the amount of each payment was determined. In short, she said that the service fee was decided on an arbitrary basis and bore no relationship to the services rendered by Company D to the Taxpayer in the production of chargeable profits of the firm. She pointed out the service fee amounted to some 61% of the gross fees of the Taxpayer and was excessive by an objective standard.

22. Finally, Miss Tse submitted that if the Board found as a fact that the service fee was an indivisible sum and was not incurred for producing the chargeable profits, the Board would be entitled to disallow the service fee in total.

Reasons for decision

23. It was explained to Mr B that it would not be sufficient to show that the method adopted by the Revenue in the assessment was arbitrary, he would need to go further and persuade us that the service fee, or any part thereof, was expense incurred in the production of profits chargeable to tax. Nonetheless, he did not give evidence. As a result, there is little explanation as to how the service fee came to be arrived at.

24. Mr B said that it was solely a matter for the Taxpayer and Company D as to what the fair and reasonable service would be. We accept the Revenue' s submission that the matter had to be assessed objectively. That is not to say that we are lifting the corporate veil. Nor are we saying that the Taxpayer is not free to decide its own affairs. The Taxpayer is free to give away part of its income as it so wishes to a related company or to a relative or indeed to any third party. The question here is whether that payment is a deductible expense in law when computing the chargeable profits. This question must be answered objectively. The agreement between the Taxpayer and Company D does not preclude us from examining whether the payment is or is not a deductible expense incurred in the production of profits.

25. Such expense must have been bona fide incurred in the production of profits. We must look at all surrounding circumstances. For example, the relation between the payer and the payee is a relevant circumstance. So is the purpose or the reason of the payment. The basis and the breakdown of the amount are also important. The lack of a rational basis may lead us to the conclusion that the amount is wholly arbitrary, lacking in commercial reality, and thus not bona fide incurred.

26. In this case, the Taxpayer has given us very little information as to how the service fee was incurred in the production of profits. The consultancy agreement referred to ' firstly' a fee $12,000 every month. There is no explanation as to how this came to be increased to $1,391,200 for the relevant period. The minutes of Company D' s board is, quite apart from the discrepancies pointed out by the Revenue, totally silent as to the reasons for the substantial increase. We do not accept the contention in the Taxpayer' s letter of 2 July 1996 that the fee was agreed on an arm' s length basis. There is no explanation as to how the fees were determined ' periodically' as stated in that letter. The schedule, which is annexed hereto as Appendix B and relied upon by Mr B, shows irregular payments and is again totally unexplained. There is no information as to how these payments relate to services provided by Company D. It looks more like a list of sole proprietor' s drawings from his own business. There is no attempt to justify any of the sums by reference to the service provided by Company D. In the circumstances, the Taxpayer failed to discharge his onus, we have no hesitation in dismissing the appeal.

27. Although the above is sufficient to dispose of this appeal, we would like to make the following additional observations. We do not know why the Revenue is not relying on section 61 of the Inland Revenue Ordinance. In our view, section 61 deals with situations such as the present. We refer to D110/98, IRBRD, vol 13, 553. Mr B frankly referred to the use of service companies as a preferred tax saving device. We have no doubt that Company D was indeed used for this purpose. Whilst a man is free to arrange his affairs in order to reduce his tax liability, section 61 is meant to catch artificial arrangements such as this whereby a taxpayer interposes a company in between himself and his own business for the deduction of personal expenses which are otherwise not deductible from his business. Mr B was the controlling partner for 4 months and the sole proprietor for the other 8 months during the material year. We do not find the case of Howe relevant to the present case. In Howe, the taxpayer sold the benefit of his royalties to a company beneficially owned by him. The overall position of Mr Howe, who controlled the company, remained the same. In future, it would be the company, rather that Mr Howe, that would be assessable on the royalties income. This is different from the current case where the income from the business, which is wholly owned by the Taxpayer, is partly channelled to Company D for tax reasons. There is no genuine commercial reason for the arrangement other than for tax saving reason. We are of the view that this amounts to an artificial transaction which may be disregarded under section 61.

28. We agree with Mr B that Practice Note No.24 is not part of the law. The Revenue accepts a percentage of 12.5% of the actual expenses as deductible expense. This may well be generous in the light of our finding above. However, as the Revenue is prepared to adopt that practice, we say no more about it.

29. For reasons given, we dismiss the appeal.

Analysis of Company D' s expenses claimed for tax deduction for year of assessment 1994/95

Expenses	**For accountancy firm**	**For director' s & connected person**	**For self company**	**Total**
	$	$	$	$
Auditors' remuneration	-	-	6,450	6,450
Bank interest and charges	2,850	-	-	2,850
Building management fee	11,097	-	-	11,097
Business registration fee	-	-	4,500	4,500
Directors' quarters expenses	-	492,747	-	492,747
Director' s remuneration	-	120,000	-	120,000
Insurance (Note)	36,402	-	36,401	72,803
Medical expenses	-	84,744	-	84,744
Motor launch expenses	-	351,568	-	351,568
Motor vehicle expenses	-	61,054	-	61,054
Miscellaneous expenses	5,821	-	-	5,821
Overseas travelling	-	36,190	-	36,190
Rent and rates	121,117	-	-	121,117
Repairs and maintenance	13,160	-	-	13,160
Salaries and staff messing	8,937	80,000	-	88,937
Subscription	25,330	-	-	25,330
Travelling and entertainment (Note)	223,456	223,455	-	446,911
Telephone and electricity	50,518	-	-	50,518
Depreciation allowance	152,126	-	-	152,126
	650,814	1,449,758	47,351	2,147,923

Note : apportioned on 50:50 basis

Excess management fee adjusted in accordance with the DIPN No.24
= $1,391,200 – ($650,814 x 112.5%)
= $659,034

Company D

7-4-1994	$	1,000.00
7-4-1994	$	1,000.00
11-4-1994	$	1,000.00
25-4-1994	$	2,000.00
6-5-1994	$	18,700.00
2-6-1994	$	12,700.00
8-6-1994	$	50,000.00
16-6-1994	$	2,000.00
23-6-1994	$	100.00
23-6-1994	$	5,400.00
23-6-1994	$	3,200.00
28-6-1994	$	6,050.00
29-6-1994	$	11,240.00
30-6-1994	$	6,650.00
27-7-1994	$	14,000.00
5-7-1994	$	14,300.00
7-7-1994	$	8,100.00
7-7-1994	$	1,170.00
7-7-1994	$	8,240.00
3-8-1994	$	12,000.00
24-8-1994	$	1,500.00
5-9-1994	$	12,000.00
9-9-1994	$	40,200.00
8-4-1994	$	17,735.30
29-4-1994	$	18,720.00
27-4-1994	$	50,000.00
24-5-1994	$	15,000.00
17-6-1994	$	25,000.00
17-6-1994	$	2,500.00
19-8-1994	$	5,000.00
25-8-1994	$	18,000.00
25-8-1994	$	30,000.00
2-6-1994	$	3,800.00
20-10-1994	$	14,000.00
26-10-1994	$	10,000.00
3-11-1994	$	12,000.00
7-11-1994	$	20,000.00
23-12-1994	$	5,000.00
29-12-1994	$	100,000.00
29-12-1994	$	25,000.00
30-1-1995	$	5,700.00
24-2-1995	$	20,000.00
24-2-1995	$	4,000.00
21-3-1995	$	40,000.00
3-10-1995	$	1,000.00
26-10-1995	$	18,000.00
27-10-1995	$	28,000.00
4-11-1995	$	1,000.00
25-11-1995	$	20,000.00
25-11-1995	$	20,000.00
28-11-1995	$	6,000.00
16-12-1995	$	1,000.00
19-12-1995	$	3,000.00

22-12-1995	$	13,000.00		
29-12-1995	$	20,000.00		
28-2-1995	$	15,000.00		
1-3-1995	$	18,000.00		
8-3-1995	$	5,000.00		
14-3-1995	$	1,000.00		
14-3-1995	$	8,000.00		
28-10-1994	$	5,000.00		
26-10-1994	$	5,000.00		
21-11-1994	$	5,000.00		
23-12-1994	$	5,000.00		
4-1-1995	$	5,000.00		
1-2-1995	$	5,000.00		
6-4-1994	$	25,511.23		
16-4-1994	$	1,791.11		
3-6-1994	$	1,836.74		
28-10-1994	$	2,886.26		
21-10-1994	$	1,105.50		
7-3-1995	$	5,497.75		
23-1-1995	$	35,848.80		
Accrued 31-3-1995	$	343,517.31		
			$	1,300,000

Mr F

17-8-1994	$	35,000		
31-3-1994	$	17,000		
			$	52,000

Mr G

13-5-1994	$	7,000		
1-6-1994	$	8,400		
6-7-1994	$	9,975		
30-7-1994	$	5,075		
22-9-1994	$	3,150		
25-11-1994	$	4,200		
			$	37,800

Mr H

18-5-1994	$	700		
15-7-1997	$	700		
			$	1,400
			$	1,391,200