

**Case No. D32/06**

**Profits tax** – whether deduction for education expenses for the taxpayers’ children allowed – whether a one-half deduction for rent and expenses on a property rented for predominantly residential purpose of the taxpayers’ family allowed even if the taxpayers’ also use the property for the purpose of their business – whether full deduction of the communication expenses from mobile phone and long distance calls because the taxpayers’ attended business outside Hong Kong is allowed – whether full deduction of motorcar expenses on a motorcar privately owned by the taxpayers’ is allowed – whether full deduction of overseas trip expenses is allowed – whether in appealing against the Revenue’s determination over the deduction of entertainment expense it is a defence to lack of supporting evidence if the taxpayers were willing and ready to produce any documents or proof to support their case but just that the Revenue did not ask for them

Panel: Anna Chow Suk Han (chairman), Alan Ng Man Sang and Adrian Wong Koon Man.

Date of hearing: 24 May 2006.

Date of decision: 30 June 2006.

Mr A is a sole proprietor, carrying out business of providing services of teachers, lectures and seminars (‘the Business’). Mr A claimed deductions of certain expenditures from the profit of the Business in relation to his and his wife Ms B’s profits tax assessment for the year 2002/03 and the personal assessment of the year 2003/04.

The expenses claimed for deduction fall under the following categories:

- (a) education allowance for Mr A and Ms B’s children;
- (b) rent, utilities and communication expenses;
- (c) motor car expenses;
- (d) overseas trips, visas and local traveling expenses; and
- (e) entertainment and meeting expenses.

On 13 February 2006, the Deputy Commissioner refused the full deductions of the expenses (‘the Determination’) as claimed by Mr A and Ms B (‘the taxpayers’) and the taxpayers appealed against the Determination.

**Held:**

1. Section 17(1) of the Inland Revenue Ordinance ('the IRO') clearly stipulates that expenses which are of domestic or private nature or are not being expended for the purpose of producing a taxpayer's profits, are not deductible. There is no room for argument that the education allowances for the taxpayer's children were of private nature and were not expended for the purpose of the Business. Hence, no deduction for education allowance is allowed.
2. In relation to the rent and utilities charges, after considering the evidence of the taxpayers and the submissions of the parties, the Board was of the view that one-third of the total amount of the rent and utilities charges allowed by the Revenue as deduction is appropriate even though Mr A may have been the person spending the most time at the property, which was occupied as the residence of the taxpayers and their three children, performing work in relation to the Business. This is because the property in question was rented predominantly for residential purpose and it was so used.
3. As to the communication expenses, whilst the taxpayers did not produce any evidence to substantiate the full claim, the Board, taking into account that Mr A also worked outside Hong Kong for the purpose of the Business, was prepared to allow one-half of the total amount as deduction instead of one-third as allowed by the Revenue.
4. It was difficult to accept that the station-wagon was purchased purely for the purpose of the Business and was never used to domestic or private purposes. Hence, the Board was of the view that the Revenue's decision to allow two-third of the total amount claimed as motor car expenses as deduction was appropriate and rejected the taxpayer's claim for a full deduction of the motor car expenses.
5. As to the taxpayer's claims for a full deduction of the overseas trips, visas and local traveling expenses, the Board was not persuaded by the Taxpayers' arguments and that they have not produced any documentary evidence to substantiate their claim. Therefore, there was no reason to disturb the two-third deduction of the total amount as allowed by the Revenue.
6. In relation to the taxpayer's claim for a full deduction of the entertainment and meeting expenses, the burden was on the taxpayer's to produce evidence to support their claim. It is not a defence for the taxpayers to say at the hearing that they were willing and ready to produce any documents or proof to support their case but just

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that the Revenue did not ask for them. Since there was no documentary evidence to support the taxpayer's claim and that the taxpayers have failed to demonstrate that the dominant element of the entertainment was for the production of chargeable profits, the Board found no reason to disturb the two-third deduction of the total amount as allowed by the Revenue.

**Appeal dismissed.**

Taxpayer in person.

Wong Siu Suk Han and Tang Hing Kwan for the Commissioner of Inland Revenue.

**Decision:**

**Appeal**

1. This is an appeal by Mr A and his wife, Ms B (collectively 'the Taxpayers') against the determination dated 13 February 2006 of Deputy Commissioner of Inland Revenue ('the Determination'). The Taxpayers have objected to the profits tax assessment for the year of assessment 2002/03 and the personal assessment for the year of assessment 2003/04 raised on them respectively. They claim that the assessment were excessive.

**Background**

2. Mr A commenced a sole-proprietorship business in the name of 'C Consultants' ('the Business') on 1 April 1995. The Business was involved in providing services of teachers, lectures and seminars.

3. (a) In his 2002/03 tax return, Mr A declared that the Business attained an adjusted loss of \$43,865.00 for the year.

(b) The Business's profit and loss statement for the year ended 31 March 2003 showed the following particulars:

|  |           |
|--|-----------|
| Service (lectures, workshops, teaching) Fees | \$309,330 |
| <u>Less:</u> Operating expenditures          |           |
| Office rent and rates                        | \$89,450  |
| Research/books/supplies/expenses             | 50,866    |
| Company car/travel/expenses                  | 35,318    |
| Travel/meetings/visas                        | 47,304    |

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|                                     |               |                          |
|-------------------------------------|---------------|--------------------------|
| Client entertainment/meetings       | 31,717        |                          |
| Education allowance                 | 53,540        |                          |
| Depreciation allowance (Equip/Auto) | <u>45,000</u> | <u>353,195</u>           |
| Loss for the year                   |               | <u><u>(\$43,865)</u></u> |

(c) Mr A and Ms B elected personal assessment for the year of assessment 2002/03.

4. (a) In his 2003/04 tax return, Mr A declared that the Business attained an adjusted loss of \$217,133 for the year.

(b) The Business's profit and loss statement for the year ended 31 March 2004 showed the following particulars:

|  |               |                           |
|--|---------------|---------------------------|
| Service (lectures, workshops, teaching) Fees |               | \$68,390                  |
| <u>Less:</u> Operating expenditures          |               |                           |
| Office rent and rates                        | \$74,375      |                           |
| Research/books/supplies/expenses             | 55,544        |                           |
| Company car/travel/expenses                  | 39,349        |                           |
| Travel/meetings/visas                        | 23,146        |                           |
| Client entertainment/meetings                | 38,289        |                           |
| Education allowance                          | <u>54,820</u> | <u>285,523</u>            |
| Loss for the year                            |               | <u><u>(\$217,133)</u></u> |

(c) In her tax return for the year of assessment 2003/04, Ms B declared a total employment income of \$482,630 for the year.

(d) The Taxpayers elected personal assessment for the year of assessment 2003/04.

5. The Business derived its profits for the two assessment years 2002/03 and 2003/04 from the following customers:

| <b>Name of customers</b> | <b>2002/03</b>          | <b>2003/04</b>         |
|--------------------------|-------------------------|------------------------|
| Company D                | \$100,080               | \$39,390               |
| Company E                | \$209,250 <sup>1</sup>  | \$ 9,000 <sup>2</sup>  |
| Company F                | --                      | <u>\$20,000</u>        |
| Total :                  | <u><u>\$309,330</u></u> | <u><u>\$68,390</u></u> |

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- <sup>1</sup> The amount of \$209,250 is the net profits from Company E after deducting the facilitator fees and travel expenses of \$129,192 from the amount of \$338,442 received from Company E for that assessment year.
- <sup>2</sup> \$9,000 represents the costs paid by Company E for purchasing reproduction rights of one of Mr A's training manuals.

6. By a tenancy agreement dated 2 July 2000, Ms B rented the property at Address G ('the Property') at a monthly rent of \$10,980 for a term of two years commencing from 1 June 2000. By a tenancy agreement dated 1 June 2002, Ms B renewed the tenancy of the Property for another two years at a monthly rent of \$9,500 commencing from 1 June 2002. The Property comprises of one sitting room, three bedrooms, a kitchen and a bathroom. Although the roof was not mentioned in the said tenancy agreements, the Taxpayers also had the exclusive use of the roof of the Property. The floor areas of the Property and the roof were respectively 700 square feet each. There was also a room of 96 square feet on the roof. The Property was occupied as the residence of the Taxpayers, their three daughters and a domestic helper. The Property was also partly used by Mr A as his office.

7. Mr A claimed deductions of certain expenditures from the profit of the Business in the said years of assessment. After investigation, the assessor did not allow the deductions fully as claimed. After determination by the Deputy Commissioner of the assessments, the Taxpayers filed their notice of appeal against the Determination. The issue under appeal is the amount or extent of deduction of the expenses which should be allowed in ascertaining the assessable profits of the Business.

8. The expenses claimed for deduction came under the following categories:
- (a) education allowances of the Taxpayers' children;
  - (b) rent, utilities and communication expenses named as 'rent and rates' in the accounts of the Business;
  - (c) motor car expenses;
  - (d) overseas trips, visas and local travelling expenses; and
  - (e) entertainment and meeting expenses.

**Statutory provision**

9. The deduction of expenses under profits tax is governed by section 16(1) of the Inland Revenue Ordinance ('IRO') which reads:

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*'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 ... '*

10. Section 17(1) and (2) of the IRO provides that certain expenses are not allowed for deduction. Section 17(1) and (2) reads as follows:

*'(1) 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, including the costs of traveling between residence and place of business;*

*(b) ...any disbursements or expenses not being money expended for the purpose of producing such profits;*

*(f) rent of, or expenses in connection with, any premises or part of premises not occupied or used for the purpose of producing such profits;*

*(2) ... nothing shall be deducted for salaries or other remuneration of, or for interest on capital or loans provided by, that person's spouse or, in the case of a partnership, any partner therein or any partner's spouse.'*

11. The burden of proof is on the taxpayer. Section 68(4) of the IRO reads as follows:

*'68. ...*

*(4) The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.*

*...'*

12. The Taxpayers appeared in person. Both of them gave evidence under oath for the purpose of their appeal.

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13. Save for the education allowances of the Taxpayer's children which were totally rejected by the Revenue, the Revenue admitted deductions of the other items of expenses at different percentages albeit not entirely as claimed by the Business. We shall deal with each item of the expenses as here below.

**Educational allowance**

14. The educational allowances claimed are respectively \$53,540 for 2002/03 and \$54,820 for 2003/04. A breakdown of the claim of \$53,540 is as follows:

| <b>Student</b> | <b>School expense</b> | <b>School</b>  | <b>Amount paid by the Business</b> |
|----------------|-----------------------|----------------|------------------------------------|
| Miss H         | \$47,300              | School K       | \$15,350                           |
| Miss I         | \$24,348              | Kindergarten L | \$24,120                           |
| Miss J         | <u>\$14,146</u>       | Kindergarten L | <u>\$14,070</u>                    |
| Total          | \$96,452              |                | <u><u>\$53,540</u></u>             |

A breakdown of the claim of \$54,280 is as follows:

| <b>Student</b> | <b>School expense</b> | <b>School</b>  | <b>Amount paid by the Business</b> |
|----------------|-----------------------|----------------|------------------------------------|
| Miss H         | \$47,300              | School K       | \$15,350                           |
| Miss I         | \$47,300              | School K       | \$15,350                           |
| Miss J         | <u>\$24,120</u>       | Kindergarten L | <u>\$24,120</u>                    |
| Total          | \$118,720             |                | <u><u>\$54,820</u></u>             |

15. Mr A's contention in this regard is that it was the norm in Hong Kong for a company to pay the education fees of its expatriate employees and since Mr A himself was not a Chinese and not a permanent resident of Hong Kong, it was his right as a business owner in Hong Kong to compensate himself with fringe benefits of that employment, including education allowance, just like any other business in Hong Kong, or the Hong Kong government.

16. Whether or not an expense is deductible, is governed by the law. In this instance, the applicable law for deduction of expenses is the statutory provisions quoted in paragraphs 9 and 10 above. Section 17(1) clearly stipulates that expenses which are of domestic or private nature or are not being expended for the purpose of producing a taxpayer's profits, are not deductible. There is no room for argument that the education allowances in question were of a private nature and were not expended for the purpose of the Business. Thus, it is correct that this item of expenditure is not allowed as deduction. Mr A's contention in this regard is untenable.

### **Rent and rates**

17. Mr A divided the expenses under this item into two categories: 'rent and utilities charges' as one category and 'communication charges' as the other. For the rent and utilities charges of electricity, gas, water and telephone line (xxxx xxxx), Mr A claimed deduction of one-half of the total amount. For the communication charges of long distance calls, telephone line (yyyy yyyy), HKBN, CTI Long distance calls and Hutchison mobile, he claimed full deduction of the total amount. The Revenue only allowed one-third of the total expenses under both categories. Mr A objected to this 'blanket' approach taken by the Revenue. He took the view that the usage of each item of the expenses should be considered and taken into account in arriving at the extent of deductibility. In respect of the rent and utilities charges of which he claimed one-half of the total amount as deduction, his claim was based on factors such as the area allegedly used by the Business over the total area of the Property, and on the amount of time spent by each individual at the Property.

18. Having carefully considered the evidence of the Taxpayers and the submissions of both parties, we are of the view that one-third of the total amount of the rent and utilities charges allowed by the Revenue as deduction is appropriate under the circumstances. At the hearing, Mr A explained to us how he made use of the Property and the roof for business purpose. We were told that one room was predominantly used by Mr A as his office and the room on the roof was now used as a storage of his business materials and some evenings after the children had gone to bed he also used the sitting room for his work. He also told us that he was the one who spent most time at the Property and thus the utilities charges were mostly consumed by him for business purpose. From the profit and loss accounts of the Business of the two assessment years in question, we can see that for the assessment year of 2002/03 the Business derived its profits from Company D and Company E and for the assessment year of 2003/04 from these two companies and also another customer, named Company F. We were told that Mr A's services to Company D were to conduct classes in Hong Kong at centres designated by Company D, and his services to Company E, in the assessment year of 2002/03, were to provide training classes in China and in the assessment year 2003/04, no training classes were necessary and its profits from Company E in that assessment year derived from the sale to Company E of reproduction rights of one of Mr A's training manuals. Thus, it is apparent that except for the preparation work and marking of papers which, as we were told by Mr A, were necessary and were carried out at the Property, the profit-producing activities did not take place at the Property. Mr A contended that since he was the one who spent most time at the Property, his claim of deduction of one-half of the rent and utilities charges was not excessive. However, we do not agree to this suggestion. The Property was rented by the Taxpayers predominantly for residential purpose and it was also so used. Even though Mr A might have spent more time at home than his wife and children, it is not necessarily true that, he was working every minute of the time when he spent at home. Further, apart from Mr A, there was also a domestic helper who worked and stayed with them at the Property. She must have spent as much time as Mr A if not more at the Property.



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|                                  |                 |
|----------------------------------|-----------------|
| China visa for Country P citizen | \$ 1,600        |
| taxi expenses                    | \$ 3,412        |
| Octopus                          | <u>\$ 2,750</u> |
|                                  | <u>\$23,146</u> |

23. In respect of the above item of expenses, Mr A claims a full deduction while the Revenue allows only two-third. Mr A explained to us that Ms B accompanied him in the trips to Island M, Country N and Country O in August 2002, October 2002 and November 2002 respectively and that her presence in those trips were necessary because he needed Ms B as his Chinese language interpreter and to bridge the cultural gap. We find this explanation unconvincing. The need of Ms B to serve as a Chinese language interpreter at those countries where Chinese language was not the main language, does not stand to reason. We were also told that a reason for the visits to those countries was to source a venue outside China for the graduation ceremony of the three years Executive Training Course for Company E, but at the end the graduation ceremony took place in City Q in China because after the 9/11 event, it was difficult or impossible for the participants to obtain visas to travel outside China. The 9/11 event took place in 2001 and the three trips took place in August, October and November 2002 respectively. At the time when the trips were taken, Mr A ought to have known that the participants of the graduation ceremony could not obtain visas to travel outside China. Thus, it is doubtful whether those trips were taken on account of Company E. Besides, we were told by the Taxpayers that their children were also taken to one of those trips. Furthermore, as informed by Company D, Mr A was seldom required to travel outside Hong Kong to perform his services for Company D. If he was required to do so, he would be reimbursed the necessary expenses. Thus, no expenses ought to have been incurred on account of Company D in any of those assessment years. Also, as from the sample agreement between the Business and Company R produced by Mr A, it was provided that trainers' transportation (in China), accommodation, food and beverages expenses would be charge to Company E. As to the facilitators' fees and travelling expenses in year of assessment 2002/03, they had already been deducted from the gross profits. As for the year of assessment 2003/04, no expenses would have been incurred on account of Company E since Mr A's contract with Company E ceased in the previous assessment year. We are also mindful of the fact that the Taxpayers had not produced any documentary evidence to substantiate the expenses alleged to have been incurred. Under the circumstances, we would not disturb the deduction of two-third of the total amount as allowed by the Revenue.

**Entertainment and meeting expenses**

24. Mr A claimed deduction of entertainment expenses of \$31,717 and \$38,289 for 2002/03 and 2003/04 respectively. The Revenue allowed only two-third of the amounts as deduction while Mr A claimed full deductions. It is the Revenue's case that, apart from the fact that there was no documentary evidence to support the claim, even if there were, the Taxpayers still had to demonstrate that the dominant element of the entertainment was for the production of chargeable profits and any private portion would be excluded. We agree to this approach taken by the

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Revenue. During the hearing, the Taxpayers complained repeatedly that they were not informed by the Revenue as to the evidence which was required to prove their case. We find this complaint unjustifiable. By its letter of 1 August 2005, the Revenue requested Mr A to provide supporting documents to substantiate the claim of business expenses such as the travel/meeting/Visa and client entertainment/meeting expenses. Also the Deputy Commissioner stated in his determination that he arrived at his decision because there was lack of evidence on the part of the Taxpayers. Indeed, the burden of proof is on the Taxpayers and it is up to the Taxpayers to provide whatever evidence they might have in their possession to support their claim. The Revenue would not know what the Taxpayers had in their possession nor was it in the position to stipulate or to name the kind of documents or proof which was necessary for Mr A's case. It is not a defense for the Taxpayers to say that they were willing and ready to produce any documents or proof to support their case but just that the Revenue did not ask for them. At the hearing, the Taxpayers produced to us some Hong Kong restaurants receipts, among which, a receipt of 'Restaurant S' bearing a date of '12/11/2002'; a receipt of 'Restaurant T' bearing the date of '12-7-2002'; and a receipt of 'Restaurant U' bearing the date of '30.6.2002'. However, it is observed from the movement record of Mr A issued by the Immigration Department which was produced by the Revenue at the hearing that Mr A was out of Hong Kong on 30 June 2002, 12 July 2002 and 12 November 2002. It was pointed out to us by Ms B that the dates on the first two receipts could possibly be 11 December 2002 and 7 December 2002. What Ms B suggested was possible but we believe that it was unlikely because in Hong Kong, save perhaps for American organizations or companies, it is the usual practice to describe a date with the day coming before the month. In any event, we still have the third receipt bearing unmistakably the date of 30 June 2002 when Mr A was not in Hong Kong. Thus, not only those receipts could not assist the Taxpayer's claims, they indeed cast doubt on the credibility of the Taxpayers. It is fortunate on the part of the Taxpayers that despite the aforesaid evidence, the Revenue did not withdraw the two-third deduction previously allowed. Under the circumstances, we do not propose to disturb the deduction as allowed and let it stand.

25. Following from the above, save for the extent of deduction as varied by us as aforesaid in respect of the communication charges, the Taxpayer's appeal is hereby dismissed and the assessments confirmed.