

1987 October 3

[LORIS, J]

IN THE MATTER OF ARTICLE 146 OF THE CONSTITUTION

MITSIOS TRADING LTD.

Applicants,

v.

THE REPUBLIC OF CYPRUS, THROUGH
THE MINISTRY OF FINANCE, AND/OR
THE COMMISSIONER OF INCOME TAX,

Respondents.

(Case No. 301/84).

Taxation — Income tax — The Income Tax Laws 1961-1981, sections 11(1) and 13(e) — Entertainment expenses — Burden of proof of an exemption or deduction is on applicant — No distinction in law between entertainment expenses and clients' and suppliers' entertainment expenses.

5 Companies — The rule against lifting the veil of incorporation — Exceptions — Income tax — Commissioner disallowed part of an amount claimed to be deducted as interest paid by applicant to its Bank on ground that such part related to personal loans made to the Directors — This case falls within the exceptions to the aforesaid rule.

10 Administrative law — General principles — Fair administration — Accepting and assessing income of employee (be she the wife of a director or not) and at the same time refusing to allow relevant deduction to employer — Contrary to principles of fair administration.

15 Administrative law — Due inquiry — Income tax — Assessing income of employer without waiting for the accounts of employer — Subsequent refusal to allow employer to deduct salary of employee — Lack of due inquiry.

20 By means of this recourse the applicant challenges the decision relating to its income tax liability for the years 1980, 1981 and 1982 and to its liability to Special Contribution for the quarters ended 30.6.80, 30.9.80, 31.12.80, 31.3.81, 30.6.81, 30.9.81, 31.3.82, 30.6.82, 30.9.82, 31.12.82.

The points in dispute between the parties are as follows:

A) The Commissioner disallowed part of the interest paid to its bank by the applicant, on the ground that the aforesaid part represented interest charged on loans for the personal use of the Director of the applicant company and not for the benefit of the company.

In this respect applicant complained, inter alia, that the respondent lifted the veil of applicants' incorporation. 5

B) Clients' and Suppliers' Entertainment Expenses and Travelling Expenses abroad.

C) Writing off machinery. In fact, the applicant claimed 100% first year allowance in virtue of s. 12(2)(d)(iii), whilst the Commissioner, taking the view that part of what was claimed to be machinery was plant allowed 100% of the value he considered as machinery and as regards that which he considered as plant he allowed capital allowance under s. 12(2)(a) of the Income Tax Laws 1961-1983. 10

D) The Commissioner refused to allow deduction of the salary of Mrs Katina Andreou, who is the wife of the managing director of the company. 15

It must be noted that the salary, which the applicant claimed that it should be deducted from its taxable income, was declared by Mrs. Katina Andreou, in her own tax returns as part of her income and that the Commissioner accepted such tax returns. 20

The Commissioner maintains that «the assessment of the income of Mrs. K. Andreou is dealt with by another section of the District Income Tax Office and when the return is received that section may raise the assessment accordingly and does not wait for the accounts of the company».

Held, annulling the sub judge decision in part: 25

(1) The rule against lifting the veil of incorporation of a company (the rule in *Salomon v. Salomon* [1897] A.C. 22) is subject to exceptions. This case falls within one of the exceptions. The respondent was entitled in examining the aforesaid issue (A), to lift the veil of incorporation.

(2) In the light of the material before the Court the sub judge decision as regards issues (A) and (C) above was reasonably open to the Commissioner. 30

(3) In income tax laws there is no distinction between entertainment expenses and clients' and supplier's entertainment expenses. Entertainment expenses are allowable as an expense wholly and exclusively incurred in the production of income on the basis of the combined effect of ss. 11(1) and 13(e) of the Income Tax Laws 1961 - 1981. The burden is always on the applicants to prove the exact amount of such expenses by furnishing documentary evidence. The burden of proof of an exemption or deduction is on the applicants. 35

In the light of the material before this Court, the sub-judice decision in so far as it relates to the issue of entertainment expenses was reasonably open to the Commissioner

5 (4) It is against the principles of fair administration to accept and assess the income of an employee - be she the wife of a director or not, - and at the same time refuse to allow a relevant deduction to the employer. Moreover as the respondent Director admits he proceeded to assess the employee without waiting for the accounts of the applicant company - the employer. This tantamounts in my view to failure to carry out due inquiry in respect of this particular item of the sub-judice decision, and this vulnerable part of same has to be annulled

*Sub-judice decision annulled
in part. No order as to costs*

Cases referred to

- 15 *Georgiades v The Republic* (1982) 3 C L R 659,
Bank of Cyprus (Holdings) Ltd v The Republic (1985) 3 C L R 1883,
Republic v KEM TAXI Ltd and Another (1987) 3 C L R 1057,
Manufacturers Life Insurance v The Republic (1967) 3 C L R 460,
HjYiannis v The Republic (1966) 3 C L R 338,
20 *Kittides v The Republic* (1973) 3 C L R 123
Tyllis and Co v Republic (1986) 3 C L R 401

Recourse.

Recourse against the income tax assessments for the years 1980-1982 and for special contribution purposes for the quarters ended during the period 30.6.80-31.12.1982 raised on applicants.

N. Pelides, for the applicants.

Y. Lazarou, for the respondents.

Cur. adv. vult.

30 LORIS J. read the following judgment. By means of the present recourse the applicants impugn the decision of the Respondent Commissioner of Income Tax by virtue of which the applicants were assessed to pay income tax for the years 1980-1982 amounting to £3,211.-, £3,165.-, and £1,483.- respectively and
35 for special contribution purposes for the quarters ended: 30.6.80,

30.9.80, 31.12.80, 31.3.81, 30.6.81, 31.3.82, 30.6.82, 30.9.82, 31.12.82 amounting to £600.-, £1,343.-, £1,411.-, £884.-, £1,344.-, £1,682.-, £2,500.-, £1,500.-, and £2,500 respectively.

The applicant company was incorporated in May, 1980 as a private company of limited liability; it took over the business of Demetrios P. Andreou, Managing Director and major shareholder of applicant company.

The auditors of the applicant company prepared and submitted to the respondent commissioner its return of income and audited accounts for the aforesaid years, which the respondent commissioner refused to accept in their totality and in particular in relation to the following items which are the substantial differences around which the present recourse revolves:

- (1) Mrs. Katina Andreou's salary;
- (2) Bank interest charged on the directors;
- (3) Clients and suppliers entertainment expenses;
- (4) Travelling expenses abroad;
- (5) Writing off machinery.

I intend to examine these items one by one, leaving, for convenience sake, Mrs. Andreou's salary at the end.

Bank Interest Charged on the Directors:

The whole of bank interest paid by applicant amounting to £2,626 for 1980 and £4,054 for 1981 respectively, claimed as deductions by the applicants, does not, in the opinion of the respondent Commissioner refer to amounts in connection with expenses wholly and exclusively incurred in the production of applicant company's income. In the opinion of the Director, in the bank loans or overdraft accounts, the following sums drawn by the directors-shareholders of the applicant company for their personal use are included:

(i) £24,000 drawn by Mrs. Katina Andreou, Director, from her husband's business before it was being taken over by applicant company in May, 1980. The sum was procured from loans provided by her husband's bankers and which were taken over by the applicant company. The sums drawn by Mrs. Katina Andreou were used for erection of a building.

(ii) £5,908.- This sum was drawn by Directors of applicant company in addition to their emoluments for the period 13.5.80 - 31.12.80.

5 (iii) £27,079. This sum was drawn by applicant company in 1981 in addition to their salaries for the year 1981.

10 The reasons why the respondent Commissioner disallowed the sums of £2,300 for 1980 and £2,100 for 1981 are stated in para. 6(b) of the facts in opposition as well as in para. 4 of the written address on behalf of the respondent. It is the stand of the respondent Commissioner that the loans in respect of which the interest was charged were loans for personal use and not for the benefit of the company and, therefore, not expenses wholly and exclusively incurred in the production of income so that to be allowable deductions under the Income Tax Law.

15 Having carefully gone through the record and the material before me, I am satisfied that the decision of the Director in respect of this item was reasonably open to him (*Lillian Georghiades v. The Republic* (1982) 3 C.L.R. 659).

20 The complaint of the applicant in connection with this item, to the effect that «the respondent by charging interest on the said £24,000.- to Mrs. K. Andreou are in effect attempting to lift the veil of incorporation and thus avoid the separate legal personality of the applicant company» is ill founded and it is hereby dismissed for the following reasons:

25 In the case of *Bank of Cyprus (Holdings) Ltd v. The Republic* (1985) 3 C.L.R. 1883, decided by the Full Bench of this Court the following were stated at p. 1889 «the case of *Michaelides v. Gavrielides* (1980) 1 C.L.R. 244, a rent control case, left no room for lifting the veil of incorporation under any circumstances. We are of the view that notwithstanding what was stated in *Michaelides* case, in a proper case there may be exceptions to the rule in *Salomon* case.»

35 In the recent case of the *Republic v. KEM TAXI Ltd* and another (R.A. 600 - judgment delivered on 21.7.1987 - still unreported)* it was held by the Full Bench of this Court that «the appellant (the

* Reported in (1987) 3 C.L.R. 1057.

Minister of Communications & Works) was perfectly entitled to pierce the veil of incorporation of the companies concerned as he did, and examine «the realities of the situation.»

(The topic of lifting the veil of a corporation is expounded at length in Palmer's Company Law 22nd ed. at pp. 160 - 163 and also in Gowers Modern Company Law 3rd ed. at pages 189-217). 5

Bearing in mind the legal aspect on this issue, as above stated, and having considered the particular facts of this case, I hold the view that the present case falls within the exceptions to the rule in *Salomon's* case and the respondent Commissioner was therefore perfectly entitled to go behind the veil of incorporation of applicant company, as he in fact did, in reaching at the sub-judice decision in connection with this item. 10

Clients' and Suppliers' Entertainment Expenses and Travelling Expenses abroad: 15

I consider it convenient to deal with these two items together.

It must be stated at the outset that I am in agreement with learned counsel appearing for the respondent (a) that in income tax laws there is no distinction between entertainment expenses and clients' and suppliers' entertainment expenses; 20

(b) that entertainment expenses are allowable as an expense wholly and exclusively incurred in the production of income on the basis of the combined effect of ss. 11(1) and 13(e) of the Income Tax Laws 1961 and 1981 as explained in the case of *Manufacturers Life Insurance v. The Republic*, (1967) 3 C.L.R. 25 460;

(c) that the burden is always on the applicants to prove the exact amount of such expenses by furnishing documentary evidence. The burden of proof of an exemption or deduction is on the applicants (*Hji Yiannis v. The Republic*, (1966) 3 C.L.R. 338 at pp. 350 - 351; *Kittides v. The Republic*, (1973) 3 C.L.R. 123 at p. 133.) 30

Having given the matter my best consideration in the light of the record and the material before me, I am satisfied that the decision of the respondent in respect of these items was reasonably open to him as well, and in the circumstances this Court should not interfere. 35

Writing off Machinery.

The claim for deduction in respect of this item may be briefly stated as follows: The applicant company in 1982 purchased at the cost of £9,035 machinery and in respect of which they claimed
5 100% first year allowance as provided by s. 12(2)(d)(iii) of the Income Tax Laws 1961-1983. The respondent allowed only £4,500 machinery to be written off, for the reasons stated in paragraphs 8 and 9 of the opposition.

Paragraph 9 reads as follows:

10 «9. Applicant Company rendered the invoices and particulars of the said new machinery to establish the components and nature of the machinery but to have a better picture whether all components were eligible for the first year capital allowance, Mr. Chr. Karakannas, Officer in charge of
15 the Nicosia Income Tax Office and Mr. Photos Papadopoulos the officer examining Applicant Company's income tax affairs visited the premises of Applicant Company on 6 December, 1983 and inspected the said new machinery. Applicant Company's auditor Mr. K. Kashoulis was present as well.
20 Upon inspection of the machinery it was found out that not all components for which the first year capital allowance claimed were machinery. Part was plant and part was machinery. Thus against the objections of Mr. Kashoulis, auditor of Applicant Company, Messrs Karakannas and Papadopoulos concluded
25 that machinery to the value of £4,500 were eligible for the 100% first year capital allowance and the rest to the value of £4,535. - were eligible for capital allowances as plant as provided under paragraph (a) of subsection (2) of section 12 of the Income Tax Laws 1961 to 1983.»

30 Having gone through the record and the material before me, in respect of this particular item, I hold the view that the decision of the respondent Commissioner on these particular items was reasonably open to him and his interpretation placed on the corresponding sections of the law cannot be faulted.

35 I shall now deal with what appears to be complaint No. 1 in the written address of the applicant, notably the salary paid to Mrs. Andreou:

40 Independently of the fact whether Mrs. Andreou is the wife of Mr. Demetrios Andreou, (a fact which can be revealed by piercing the veil of the Corporation, a legal point which I had the

opportunity of dealing with, earlier on in the present judgment), the fact remains that Mrs. Andreou submitted her annual income tax returns for the years 1980-1982 which the respondent Commissioner accepted and the tax was accordingly paid. In this declaration her salary declared and accepted by the Commissioner was £1,080 for 1980, £1,600 for 1981; and £2,400 for 1982.

Now, the respondent Commissioner in the present case does not allow these amounts to be deducted from the applicant company as salary paid to an employee, and although he admits that Mrs. Andreou's return for 1980 was accepted and an assessment was raised according to her declaration, he maintains that «the assessment of the income of Mrs. K. Andreou is dealt with by another section of the District Income Tax Office and when the return is received that section may raise the assessment accordingly and does not wait for the accounts of the company.»

It is against the principles of fair administration (*vide Tyllis & Co v. Republic* (1986) 3 C.L.R. 401 at p. 413) to accept and assess the income of an employee - be she the wife of a director or not, - and at the same time refuse to allow a relevant deduction to the employer. The explanation given by the respondent Commissioner - set out verbatim above - points also at another factor which militates against the validity of the sub-judice decision in respect of this particular item: «failure to carry out due inquiry.» Mrs. Andreou, the employee submitted her annual income returns declaring therein the amounts she received from the applicant company as salaries for the respective years of assessment; her statements in the returns were accepted by the respondent Commissioner and he proceeded to assess her income accordingly; I hold the view that it was his duty at the same time to carry out due inquiry, in order to ascertain whether her employer, the applicant company (declared in her returns as such) had stated in the relevant returns whether such a salary was paid to the aforesaid employee or not. As the respondent Director admits he proceeded to assess the employee without waiting for the accounts of the applicant company-the employer. This tantamounts in my view to failure to carry out due inquiry in respect of this particular item of the sub-judice decision; and this vulnerable part of same has to be annulled.

In the result the sub-judice decision as regards all other items was reasonably open to the respondent Commissioner and it is hereby confirmed; that part of the sub-judice decision which refers to Mrs. K. Andreou's salaries for the years 1980-1982 is
5 hereby declared null and void and of no effect whatsoever for the reasons above stated.

Let there be no order as to costs.

*Sub judice decision
partly annulled. No
order as to costs.*

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