

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D30/88
Case No. D31/88
Case No. D32/88

Profits Tax - deductions - interest - borrowing by company secured by charge over deposit owned by director earning tax-free interest - whether interest deductible - whether an incorporated company is a 'body of persons' - ss 16(2)(d)(ii) and (iii) of the Inland Revenue Ordinance.

Panel: T J Gregory (chairman), Raymond J Faulkner and Geoffrey Hui Jor Yat.

Date of hearing: 1 August 1988.
Date of decision: 16 August 1988.

The taxpayer company claimed a deduction for interest which it had paid on bank borrowings. The borrowings were secured over a time deposit made by the company's directors with a financial institution in Hong Kong. The interest paid on these deposits was not subject to tax.

The IRD disallowed the taxpayer's claim to a deduction for the interest which it had paid on the borrowings. It argued that the taxpayer was a 'body of persons, whether corporate or unincorporate' for the purposes of section 16(2)(d)(ii), which operates to deny a deduction for interest on borrowings by such entities where the borrowings are secured over directors' deposits.

The taxpayer appealed. It argued that, being a company, it was not a 'body of persons' and that its position should be determined solely by reference to section 16(2)(iii) which applies expressly to 'corporations'.

Held:

The interest payments were not deductible.

- (a) The taxpayer was both a 'body of persons' and a 'corporation', and its entitlement to a deduction was therefore to be determined by reference to both sub-sections 16(2)(ii) and (iii).
- (b) In determining a company's entitlement to deduct interest on borrowings which are secured over directors' deposits, it is irrelevant whether the deposits represent the directors' personal funds or funds withdrawn from the company.

Appeal dismissed.

INLAND REVENUE BOARD OF REVIEW DECISIONS

Cases referred to:

Assam Railways & Trading Co Ltd v CIR (1935) 18 TC 509
Cape Brandy Syndicate v IRC (1921) 12 TC 266
Mangin v CIR (NZ)(1970) 70 ATC 6001

D J Gaskin for the Commissioner of Inland Revenue.
Robert Lew of James Lew & Co for the taxpayer.

Decision:

1. THE FACTS

The facts, which are not in dispute, are as follows:

- 1.1 The Taxpayer was incorporated in Hong Kong pursuant to the Companies Ordinance in 1980.
- 1.2 In the relevant year of assessment, 1984/85, the Taxpayer had banking facilities, some part of which was secured by a time deposit belonging to its directors, placed with a financial institution carrying on business in Hong Kong.
- 1.3 In its tax computation the Taxpayer included, inter alia, the interest paid on the secured banking facilities as a deduction.
- 1.4 Having received its tax computation, the assessor issued a letter of enquiry to the Taxpayer requesting further information as to the bank overdraft interest and advising that he would raise an assessment on the Taxpayer in the amount of the profit returned in its tax computation pending the submission of the required information. Thereafter correspondence was exchanged between the Revenue and the Taxpayer's representative in which the submissions made at the hearing of the appeal were put forward. In due course, the assessor advised the Taxpayer's representative that he did not agree with the submissions and raised an additional profits tax assessment on the Taxpayer, the effect of which was to disallow the claim for the deduction in respect of the interest paid on that part of the bank borrowings which, during the year of assessment in question, had been secured by a time deposit belonging to directors.
- 1.5 The Taxpayer's representative lodged an objection against this additional assessment and, in due course, a Commissioner's determination was issued confirming the additional profits tax assessment.
- 1.6 No tax had been deducted from the interest paid on the time deposit which secured the banking facilities of the Taxpayer.

INLAND REVENUE BOARD OF REVIEW DECISIONS

2. DOCUMENTATION

The Board had before it the following documents:

2.1 The Taxpayer

- 2.1.1 Extracts from its audited accounts for its year ended 31 March 1985;
- 2.1.2 Tax computation for the year of assessment 1984/85;
- 2.1.3 Notice of assessment and demand for profits tax - year of assessment 1984/85;
- 2.1.4 The Commissioner's determination dated 21 November 1987; and
- 2.1.5 The Taxpayer's notice and grounds of appeal dated 17 December 1987.

2.2 Submissions

At the hearing, the Taxpayer's representative handed up and took the Board through a written submission as did the Revenue's representative. Additionally, the Revenue's representative referred to:

- 2.2.1 The official record (Hansard) of the proceedings of the Legislative Council during the reading of the Bill which became Ordinance 2 of 1971 which amended the then definition of 'person';
- 2.2.2 Pages 197 and 198 from the Shorter Oxford English Dictionary (edition not identified) for the (fourth) meaning of the word 'body';
- 2.2.3 Page 36 of 'A Dictionary of Tax Definitions' for the meaning of the word 'company';
- 2.2.4 Page 430 of Jowitt's 'The Dictionary of English Law' for the meaning of the word 'companies';
- 2.2.5 The Cape Brandy Syndicate v The Commissioners of Inland Revenue (1921) 12 TC 266;
- 2.2.6 Mangin v New Zealand Commissioner of Inland Revenue (1970) 70 ATC 6001;
- 2.2.7 Section 19 of The Interpretation and General Clauses Ordinance, Cap 1;
- 2.2.8 Paragraphs 134, 135 and 136 of the Financial Secretary's 1984/85 Budget Speech; and

INLAND REVENUE BOARD OF REVIEW DECISIONS

- 2.2.9 Paragraph 3 of the Explanatory Memorandum to the Bill which became the Inland Revenue (Amendment) Ordinance Cap 36 of 1984.

3. THE RELEVANT PROVISIONS OF THE INLAND REVENUE ORDINANCE

The relevant provision of the legislation referred to by the Taxpayer's representative are as follows:

- 3.1 Section 2: three of the definitions which we quote in full:
- 3.1.1. "'body of persons" means any body politic, corporate or collegiate and any company, fraternity, fellowship and society of persons whether corporate or not corporate;'
- 3.1.2. "'corporation" means any company which is either incorporated or registered under any enactment or charter in force in Hong Kong or elsewhere but does not include a co-operative society or a trade union;'
- 3.1.3. "'person" includes a corporation, partnership, trustee, whether incorporated or unincorporated, or body of persons;'
- 3.2 Section 16(1)(a): which permits the deduction of, inter alia, interest paid with respect to money borrowed for the purpose of producing profits but only if the conditions set out in section 16(2) are satisfied.
- 3.3 Section 16(2)(d): which precludes the deduction of interest if the repayment of the principal or interest is secured as therein provided.

4. THE ISSUE

- 4.1 In simple terms, the issue between the Taxpayer and the Revenue is whether sub-section 16(2)(d)(ii) permits the Revenue to disallow the deduction of the interest paid on the borrowings of the Taxpayer which were secured by the deposit of the directors' time deposit receipt.
- 4.2 The grounds of appeal may be summarized that, as there is a distinction between 'body of persons' and 'corporation', sub-section 16(2)(d)(ii) can only apply to those organisations caught by the definition 'body of persons' and sub-section 16(2)(d)(iii) can only apply to these organisations caught by the definition 'corporation'.

5. THE CASE FOR AND SUBMISSION ON BEHALF OF THE TAXPAYER

- 5.1 The case for the Taxpayer may be succinctly stated to be that the Taxpayer is not a 'body of persons', as defined in section 2, whereby the condition set out in sub-section 16(2)(d)(ii) cannot apply to it as the application of the sub-section is limited to a 'body of persons'.

INLAND REVENUE BOARD OF REVIEW DECISIONS

- 5.2 The Taxpayer's representative put forward the following propositions:
- 5.2.1 The Taxpayer is not a 'body of persons', the expression used in sub-section 16(2)(d)(ii), as defined in section 2; it is a 'corporation' as defined in section 2. The Taxpayer cannot be a 'body of persons' and a 'corporation' simultaneously. As the Taxpayer is a corporation, that sub-section, because of its wording, cannot be applied to it.
- 5.2.2 If the legislation is ambiguous, the appeal should be allowed whereafter it would be for the Revenue to request the courts to determine the issue.
- 5.3 In support of the first proposition, the Taxpayer's representative submitted:
- 5.3.1 A company duly incorporated under the Laws of Hong Kong cannot fall within the definition 'body of persons' in section 2 as it falls within the definition 'corporation' in section 2. It has to be one or the other, but it cannot be both. No authority was cited in support of this proposition.
- 5.3.2 The definition of 'body of persons' is to be read with the word 'body' attached to 'corporate' to create the expression 'body corporate', and the word 'company' attached to 'of persons' to create the expression 'company of persons'. As neither of the expressions 'body corporate' and 'company of persons' is defined, these expressions have to be construed by referring to other statutes or common usage in the English language.
- 5.3.3 Whilst in normal usage both of the expressions referred to in 5.3.2 above mean any group of people who come together to operate in the form of an organization, this interpretation does not assist as a company is a legal entity with an existence separate from and distinct to the person or body of persons who operate the company.
- 5.3.4 The term 'corporation', as defined and employed throughout the Ordinance, is not and does not fall within the definition 'body of persons'. Additional rules apply to a 'corporation'. Unless this is accepted, the Ordinance becomes inoperable when rules that apply to a 'corporation' conflict with those that apply to a 'body of persons'. The most obvious example of such conflict is section 14 which charges that every person who carries on a trade in Hong Kong is chargeable to tax at the current standard rate of profits tax unless that person is a corporation, in which case the higher corporation profits tax rate applies. If the Commissioner contends that a company is a 'body of persons' by virtue of it being a 'body corporate' or an 'incorporated company of persons', and a company is also a

INLAND REVENUE BOARD OF REVIEW DECISIONS

'corporation' by virtue of it being incorporated under any enactment, then an irreconcilable quandary is created as to whether this person is to be charged at the standard rate or the higher corporation rate.

- 5.3.5 The definition of 'person' in section 2 includes both a 'corporation' and a 'body of persons' which clearly distinguishes one from the other. If they were to mean the same thing, it would not be necessary for both terms to be included.
- 5.3.6 Section 16(2) is an anti-avoidance provision in that it prevents directors of a company from withdrawing revenue-producing assets and converting them into tax-saving assets, a transaction which is often fictitious and without any predominant business purpose other than to save tax.
- 5.3.7 In this case, the time deposit which secured the banking facilities of the Taxpayer was not out of monies withdrawn from the Taxpayer but was out of the personal resources of the directors. No evidence was adduced with respect to this, but the Board does not consider this statement relevant.
- 5.4 No submission was made by the Taxpayer's representative in support of the second of his propositions.

6. SUBMISSIONS ON BEHALF OF THE REVENUE

- 6.1 The words 'politic', 'corporate' or 'collegiate' in the definition of 'body of persons' are adjectives whereby the definition is to be read by inserting the word 'body' before the words 'corporate' and 'collegiate'.
- 6.2 The word 'company' in the definition of 'body of persons' and in the definition of 'corporation' are equivalent.
- 6.3 A company incorporated in Hong Kong meets both of these definitions.
- 6.4 There is no rule of construction which states that definitions are mutually exclusive.
- 6.5 The common interpretation of the word 'body' when used at law is defined in the Concise Oxford English Dictionary as 'an artificial "person" created by law; a corporation. Always with defining adjective as b[ody] corporate, etc'.
- 6.6 Further definitions of 'company' were cited from the two other dictionaries identified in paragraphs 2.4.4 and 2.4.5 above.
- 6.7 Taxing statutes are to be strictly construed. In the words of Rowlatt J in The Cape Brandy Syndicate case, refer paragraph 2.4.6 above:

INLAND REVENUE BOARD OF REVIEW DECISIONS

'in taxation you have to look simply at what is clearly said. There is no room for any intendment; there is no equity about a tax; there is no presumption as to tax; you read nothing in; you imply nothing, but you look fairly at what is said and at what is said clearly and that is the tax.'

- 6.8 This position is further clarified in the Mangin case, refer paragraph 2.4.7 above. In the words of Donovan LJ:

'Thirdly, the object of the construction of a statute being to ascertain the will of the legislature it may be presumed that neither injustice nor absurdity was intended. If therefore a literal interpretation would produce such a result, and the language admits of an interpretation which would avoid it, then such an interpretation may be adopted.'

- 6.8.1 If the Board has any lingering doubt, it is permitted to consider the reasons for the enactment, refer the next paragraph in the same speech:

'Fourthly, the history of an enactment and the reasons which lead to its being passed may be used as an aid to its construction.'

- 6.9 Relying on this proposition, the Revenue referred to:

- 6.9.1 The Financial Secretary's 1984/85 Budget Speech, particularly paragraphs 134, 135 and 136, which dealt with the need to protect the public revenue as a result of the exemption, with effect from 17 October 1983, from interest tax of interest paid on deposits made in Hong Kong currency with a financial institution carrying on business in Hong Kong;

- 6.9.2 Reference was also made to the Explanatory Memorandum to the consequential Inland Revenue (Amendment) Bill, paragraph 3 of which reads:

'Section 16 of the principal Ordinance is amended (by Clause 4) to discourage the use of loan capital secured against deposits with financial institutions with the object of avoiding the payment of profits tax'.

7. REPLY ON BEHALF OF THE TAXPAYER

In his reply, the Taxpayer's representative stated that referring to the history of the legislation (which the Board understood to refer to the paragraphs in the Financial Secretary's Budget Speech referred to in paragraph 6.9.1 and the Explanatory Memorandum to the Inland Revenue (Amendment) Bill referred to in paragraph 6.9.2 above) did not resolve the

INLAND REVENUE BOARD OF REVIEW DECISIONS

issue. Citing The Assam Railways & Trading Co Ltd v The Commissioner of Inland Revenue (1935) 18 TC 509, he stated that the intention is to be ascertained from the wording of the statute and the background may not be considered.

8. REASONS FOR DECISION

8.1 Ambiguity

The Board is satisfied that there is no ambiguity in the drafting of the relevant provisions of the Ordinance. It has therefore been unnecessary for the Board to refer to the Financial Secretary's Speech or the Explanatory Memorandum to the Inland Revenue (Amendment) Bill 1984 or to consider whether it would have been proper to do so.

8.2 Rules of Construction

The Board is satisfied that there is no rule of construction which requires definitions to be treated as mutually exclusive. If that is the intention, the wording of the legislation will so state or indicate.

8.3 Ambit of Definitions

The Board is satisfied that the three definitions quoted in paragraph 3.1 above are neither expressly nor implicitly made mutually exclusive by the Ordinance. Accordingly, a potential taxpayer can fall into all as opposed to only one of the definitions.

8.4 Construction of the Definitions

8.4.1 'body of persons'

The Board is satisfied that in the definition of 'body of persons', the words 'politic, corporate or collegiate' are used as adjectives whereby the definition includes a 'body corporate' an expression which in normal usage is synonymous with 'corporation'.

8.4.2 'corporation'

This definition calls for no comment.

8.4.3 'person'

This definition does not create the distinction submitted by the Taxpayer's representative, refer 5.3.5 above. It does not purport to define, that is, by the use of the word 'means'; it is no more than a convenient means of eliminating the need to repeat the words included wherever they would, otherwise, have to be set out in full.

INLAND REVENUE BOARD OF REVIEW DECISIONS

8.4.4 The Board is satisfied that the three definitions in section 2 of the Ordinance, namely 'body of persons', 'corporations' and 'person' are neither intended to nor do they create or permit the distinctions upon which the Taxpayer's appeal is founded.

8.5 Applicability of sub-section 16(2)(d)(ii)

8.5.1 The Board is satisfied that the words 'body of persons, whether corporate or unincorporate' in sub-section 16(2)(d)(ii) includes a company incorporated under the Companies Ordinance, Cap 32.

8.5.2 When considering sub-section 16(2)(d)(ii) and the definition 'body of persons', and applying normal rules of construction, namely, to afford the usual meaning to the words used, it is patent that the sub-section is to apply to a corporation. The words 'shareholders' and 'director' are commonly understood to be the persons or entities who own shares in or direct the affairs of a company or corporation. To accept the Taxpayer's representative's submission would be to give an uncommon interpretation to these words and accept that these words have been deliberately used in a legal instrument in a way which would not normally be expected.

8.5.3 It follows from the construction placed by the Board on the definitions that the Board is of the view that sub-section 16(2)(d)(ii) applies to the appellant Taxpayer.

8.6 Propriety of the additional Profits Tax Assessment

As, factually, during the year of assessment in question the Taxpayer had some banking facilities secured by the deposit by its directors with the lending financial institution of the instrument of title to a 'time deposit' placed with a financial institution carrying on business in Hong Kong, the Board is satisfied that sub-section 16(2)(d)(ii) was properly invoked. Thus, the assessor was correct in raising the additional profits tax assessment which is the subject matter of this appeal.

9. DECISION

For the reasons given, the Board finds in favour of the Commissioner and dismisses the appeal.