IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION

COURT OF APPEAL

CIVIL APPEAL NO. 145 OF 1997
(ON APPEAL FROM INLAND REVENUE APPEAL NO. 2 OF 1996)

BETWEEN

COMMISSIONER OF INLAND REVENUE	Appellant (Appellant)
and	
NATIONAL MUTUAL CENTRE (HK) LTD	Respondent (Respondent)

Coram: Hon. Nazareth, V.P., Leong & Rogers, JJ.A. in court
Dates of hearing: 6th, 7th & 8th May 1998
Date of handing down judgment: 23rd June 1998

J U D G M E N T

Rogers, J.A. :

Introduction

This is an appeal by the Commissioner of Inland Revenue from a judgment of Stone J. dated 25th March 1997. By that judgment the Judge dismissed an appeal by the Commissioner by way of case stated pursuant to Section 69(1) of the Inland Revenue Ordinance, Cap.112. Although the Case Stated is dated 10th January 1996, the Determination in respect of which the appeal was brought was dated 24th December 1992.

Background

The Taxpayer, the Respondent herein, was incorporated in 1985 under the name Bartlefield Ltd. Its business is apparently that of a property investment company investing for the purposes of rental income. On 4th February 1987, a number of agreements were signed involving the Taxpayer, its parent company together with another subsidiary company of the parent company and a consortium of banks. The consortium will be referred to collectively as the "banks". For the purposes of this case. the other subsidiary of the parent company has been treated as having an identity of interest with the parent company and the parent company has been treated as if it had been the sole lender. It should also be noted that the Taxpayer was a wholly owned subsidiary of the parent company.

A loan of HK$300,000,000 was obtained from the banks to finance the acquisition of a property in Hong Kong purchased by the Taxpayer. The money borrowed from the banks was not however sufficient for the Taxpayer's purposes and a further loan in the sum of HK$128,600,000 was borrowed from the parent company and its subsidiary. The parent company entered what was termed a "Shareholders' Subordination Agreement". The parties to that agreement included the parent company and its subsidiary, the Taxpayer and the banks. Corresponding to that agreement was what was termed a "Subordinated Loan Agreement". The combined effects of these two agreements was to ensure that any liabilities arising from the loans made by the parent company to the Taxpayer would be subordinate to the rights of the banks under their loan agreements. It will be necessary to examine the wording of the Shareholders' Subordination and Subordinated Loan agreements later.

The claim to deductions

This case arises from claims to deductions of amounts in respect of interest under loans made by the parent company to the Taxpayer. By the Determination dated the 24th December 1992, the deductions were disallowed by the Commissioner. There was a profits tax assessment for the year of assessment 1987/1988 and for the year 1988/1989. There were additional profits tax assessments for the years of assessment 1988/1989 and 1989/1990. The specific figures in these assessments are not relevant to this appeal. The Case Stated raised matters of general principle and there was no dispute between the parties that upon the resolution of the principles upon which the assessments should be made, the matter could be remitted to the Board of Review should it be necessary.

The Board of Review

The Taxpayer appealed the profits tax assessments and additional profits tax assessments to the Board of Review. The Case Stated indicates that on 26th October 1993 when the Board delivered a written decision allowing the appeal and ordering the discharge of the notices of additional assessment, for some reason it probably omitted to deal formally with the 2 profits tax assessments for the years 1987/88 and 1988/89. This is

perhaps slightly ambiguous from the Case Stated. The Judge below clearly thought those assessments had been dealt with by the Board. It is agreed on all sides that the same questions arise in respect of those assessments as in respect of the notices of additional assessment and the same principles apply. It is also agreed that the technicality can be cured, if necessary, by remitting the matter to the Board of Review.

The questions of law in respect of which the opinion of the Court was sought were as follows :-

(1) Whether the Board has erred in law in finding that the interest in question was incurred within Section 16(1) of the Inland Revenue Ordinance (the Ordinance).

(2) Whether the Board has erred in law in finding that the interest in question was payable within Section 16(1)(a) of the Inland Revenue Ordinance.

(3) Whether the Board has erred in law in finding that at the material times the interest in question was chargeable to tax under the Ordinance by operation of the then Section 28(1).

(4) Whether the Board has erred in law in finding that insofar as the interest in question was concerned, the condition set out in Section 16(2)(c) of the Ordinance has been satisfied.

(5) Whether the Board has erred in law in finding that the interest in question was deductible in the computation of assessable profits of the Appellant in the relevant years.

The Court below answered all the questions in the negative, found that the decision of the Board was correct and dismissed the appeal.

Relevant sections of the Inland Revenue Ordinance

The Case Stated required the Court's consideration of Section 16 of the Inland Revenue Ordinance, specifically Sections 16(1), 16(1)(a) and Section 16(2)(c). In particular, there fell for determination in the appeal, the meaning of the words "incurred", "payable" and "chargeable". For convenience, those Sections will be set out :-

> "16(1) 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, including-

(a) where the conditions set out in subsection (2) are satisfied, sums payable by such person by way of interest upon any money borrowed by him for the purpose of producing such profits, and sums payable by such person by way of legal fees, procuration fees, stamp duties and other expenses in connection with such borrowing;

(2) The conditions referred to in subsection (1)(a) are that-

(c) the money has been borrowed from a person other than a financial institution or an overseas financial institution and the sums payable by way of interest are chargeable to tax under this Ordinance;"

Whether the Board has erred in law in finding that the interest in question was incurred within the meaning of Section 16(1)

Crucial to the determination of this issue is the construction of the agreements which have already been referred to.

Shareholders' Subordination Agreement

The purpose of this Agreement, as is evident from its content, was to ensure that the banks which lent money to the Taxpayer would be paid in full prior to any payment to the parent company. After setting that out, the Agreement then provided by Clause 2(A)(2) that :-

"Each of the Parent Companies agrees that it shall have no entitlement to receive any amounts which it would but for the provisions of this Agreement have been entitled to receive on account of the Subordinated Indebtedness prior to the Termination Date, whether upon the winding up or dissolution of the Borrower or either Owning Company or otherwise."

"Termination Date" is defined in the Agreement as being the date upon which the banks had been repaid all that would or may become payable.

Under Clause 2(C) it was provided that :-

"Each of the Parent Companies undertakes that it will not, prior to the Termination Date ask, demand, sue for, take or receive, directly or indirectly, whether by exercise of set-off, counterclaim or in any other manner, payment of any Subordinated Indebtedness and will not exercise any other rights against the Borrower or either Owning Company in competition with the Superior Creditors and will not prove in the winding up of the Borrower or any Owning Company for any part of the Subordinated Indebtedness."

The Subordinated Loan Agreement which was made between the parent company and the Taxpayer provided that the Parent Company would lend the Taxpayer HK$64,300,000. (The other subsidiary lent a like amount under an agreement with terms which corresponded.)

Clause 2 of the Loan Agreement provided as follows:

"2. The Indebtedness shall bear interest at the rate of sixteen per cent per annum (16% p.a.) compounded annually."

The indebtedness was defined in the Subordinated Loan Agreement broadly and in terms that would include interest payments.

Clause 3 of the Agreement then stipulated that so long as monies remained owing to the banks, the loan was subject to the following terms and conditions:-

"(a) the Indebtedness shall not be subject to payment of interest (although interest may accrue thereon);

(b) the Subordinated Lender shall not be entitled to receive on account of the Indebtedness prior to the date of final payment in full to the Principal Lenders of all monies due to the Principal Lenders by the Borrower under the Loan Agreement any amounts whether upon the winding up or dissolution of the borrower or for any other reason whatsoever;

(c) the Indebtedness is and shall remain unsecured by any mortgage, charge, debenture or other security of any kind over the whole or any part of the assets of the Borrower and is not and shall not be capable of becoming subject to any right of set-off or counterclaim."

Finally Clause 3 stipulated that the terms of the Shareholders' Subordination Agreement were in effect incorporated into the Subordinated Loan Agreement which was made subject to those terms.

The combined effect of these agreements was that there were loans, effectively for the purposes of the Determination, by the parent company. Those loans were subject, as indeed nearly every loan is, to the payment of interest. The interest was 16% compounded annually. The date of re-payment of those loans and the date of payment of the interest was delayed for at least as long as necessary for the bank loans to be paid off prior to any payment of principal or interest under the subordinated loans.

If there were an insolvent winding-up prior to the Termination Date the loan(s) by the parent company and the interest would not be paid. In those circumstances, the effect of Clause 2(C) of the Shareholders' Subordination Agreement would be that it would be a breach of that Agreement for the parent company to claim any amount in the winding-

up, whether that amount were to be in respect of principal or interest. Although on a strict construction of that Agreement, Clause 2(C) would prevent a proof of debt being lodged even after the Termination Date, since the Shareholders' Subordination Agreement would have terminated upon the payment to the banks of their loans and any interest due, Clause 2(C) would be unenforceable if the Termination Date had occurred prior to any winding-up. Furthermore. on a solvent dissolution of the Taxpayer, the banks would clearly be paid their principal and interest and the parent company, being the sole shareholder, would be in a position of enjoying the distribution of all remaining assets after the debts were paid.

It was clearly necessary that if payment of any interest or principal by the Taxpayer to its parent were to be postponed, or subordinated, to the payment of all principal and interest to the banks, the only way that could be achieved in an insolvent winding-up would be to prevent the parent company proving for any debt. This would be the surest way of altering the effect of the statutory priority in respect of payment of debts.

It was strongly argued on behalf of the Commissioner that the effects of the 2 Agreements, and in particular Clause 3 of the Subordinated Loan Agreement, was that until the Termination Date, the Taxpayer had no currently enforceable obligation or liability. It was said that any such liability would, and could, only arise after the Termination Date.

That does not, however, appear to be the correct legal interpretation of the effect of the 2 Agreements. The debts and liability for interest under the Subordinated Loan Agreement existed from the date of the subordinated loans but the time for re-payment and payment respectively was postponed until the Termination Date. On the Termination Date, no new liability would arise but the contractual prohibition upon the Taxpayer from discharging those liabilities would be removed. Looked at in another way, there was no way in which the Taxpayer could avoid the liability to repay the loans and pay interest to the parent after it had paid the banks and thus caused the Termination Date to occur.

The only circumstances in which the Taxpayer would never have to pay interest to the parent is if it never paid the banks or if there was a winding-up prior to the Termination Date. The former state of affairs would not be something which the law could contemplate as a realistic possibility. The contractual documents relating to the loans from the lending banks were not part of the Case Stated but on the basis that these were loans which were repayable, the Court must approach this on the basis that a Termination Date would occur. To contemplate that the loans would never be repaid as a matter of perpetuity is to look upon the commitment to the lending banks as a commitment different to that which it in fact was, namely a loan. A loan by definition is a debt which is repayable and which attracts interest at the very least from the date of demand for repayment.

The other circumstance, namely a winding-up, in effect meant the demise of the taxpayer. To that extent, unless and until the taxpayer were willing or were forced to cease to exist, that liability, coupled with the no small liability to its parent to pay compound

interest of 16% persisted. As the Subordinated Loan Agreement itself provided, interest accrued although the payment of interest could not be made.

Legal liability

It follows from the above analysis of the two Agreements that a legal liability for the interest was assumed by the Taxpayer. That liability did not entail a "presently enforceable" legal obligation or liability to pay interest, if by that is meant that action could have been brought by the parent company prior to the Termination Date for immediate recovery of interest. That however is not what is required by Section 16(1) of the Ordinance. That Section requires that the expenses must be incurred during the basis period for the year of assessment. The Section does not stipulate those expenses must be of such nature that they are dischargeable immediately. There is no reason why the contractual terms under which the expenses are incurred should not stipulate payment to take place in the future.

It was argued that for a liability to be incurred there must be a corresponding right which was vested in the person to whom the liability was owed. That does not seem to be a matter which could alter the outcome of this case. Although the parent company may have contractually bound itself not to receive any interest prior to the Termination Date, there can be no doubt that it acquired rights subject, as they may have been, to considerable restrictions.

The leading case on the construction of the word "incurred" in Section 16(1) of the Ordinance is Lo & Lo v. CIR [1984] 1 HKTC 34. Not unnaturally each side sought to rely on that Decision. That case concerned the question as to whether sums could be allowed under Section 16(1) which were allocated for the purpose of paying long term service benefits to employees who had been employed by the solicitors' firm for 10 years. The firm had come under an obligation to make payments to such employees upon their retirement but the payments would not be made until the employees retired. Lord Brightman at p.72 said :-

> "For the reasons already given, 'an expense incurred' is not confined to a disbursement, and must at least include a sum which there is an obligation to pay, that is to say, an accrued liability which is undischarged."

Mr. Fok, on behalf of the Commissioner, sought to strengthen his argument that there should be a "presently enforceable right" upon the statement of Lord Brightman where he said:

> "Such employees do not have any present right to demand payment, and different considerations may apply in their cases."

That was said in reference to and questioning a passage in the judgment of Hunter, J. which implied that deductions might be considered in respect of all employees i.e. including those in the process of qualifying for long service.

What Lord Brightman was referring to however, was that the long term employees were in a position where all they had to do would be to retire and then they could demand payment. In such cases, the payments were secured for long service employees. Those payments were liable to be increased year by year upon the increasing salaries of the employees (see the terms of Clause 5 of the conditions of employment set out at page 57 of the report.) In talking of a present right to demand payment, Lord Brightman had in mind that the retirement of the relevant employee had to take place before payment could be demanded.

He also had in mind the possibility that the notional employee might be dismissed for dishonesty or other reasons and lose any entitlement to long service pay. Nevertheless he regarded the right of the employee to receive long service payment as vested once he had achieved 10 years service because it was "defeasible only in one possible but unlikely event". [It might be noted here that it is not clear from the report of the case as to whether the personal representatives of a deceased long service employee who died in service would be entitled to the benefit.] The employees who had already served 10 years had passed the threshold whereby it could be said that they had acquired some rights albeit their enforcement was suspended. The employees who had not yet served 10 years had not reached that threshold. Hence in considering whether a liability had been incurred and whether a right had been vested, the Privy Council considered that the right was vested and the expense incurred in a situation where the legal liability would not become enforceable only if an unlikely event happened before the date for payment occurred.

Likewise in the present case, events and in particular the Termination Date had to occur before any interest could be demanded by the parent. Nevertheless, as Mr. Kotewall, S.C. argued, as a matter of commercial reality, the payment of capital and interest to the banks would be made. The reality, let alone the commercial reality, was that the Taxpayer had committed itself to a liability to pay interest to its parent company. There was only one factor which would prevent that interest being paid namely if the lending banks were not re-paid in full. The dissolution of the Taxpayer prior to the Termination Date would create a circumstance in which the interest would not be paid. From the taxation point of view, the lack of payment in such circumstances would be the equivalent of lack of payment in any situation where an insolvent company were dissolved owing debts which it had occurred.

Although it might be said that the Subordinated Loan Agreement was not complete in itself in that there was no stipulation as to the date of payment either of capital or interest, there is no doubt that the Subordinated Loan Agreement was enforceable and should the Termination Date have occurred, there is no doubt that the parent company could have enforced the loan by demanding payment of capital or interest.

Neither was the incurring of the liability to pay capital or interest contingent upon the Termination Date. That liability was incurred upon the execution of the Subordinated Loan Agreement and the acceptance of the loan. There is nothing which the taxpayer could have done to avoid liability other than to fail to pay the lending banks in full. In the circumstances, the first question posed in the case stated was correctly answered in the negative.

Payable

In the Court below, it was argued on behalf of the Commissioner that the word "payable" in Section 16(1)(a) meant payable during the basis period. That argument was not pursued on appeal.

Once it is conceded that for the purposes of the sub-section debts which have been incurred might be payable at some future date, then the question posed by the word "payable" was as Mr. Fok argued, much the same as the question which arose under the interpretation of the word "incurred". The word "payable" means that there is a sum which falls to be paid. To interpret the word "payable" as meaning "due" or "owing" is to introduce an unnecessary connotation of immediacy.

For the reasons explained in relation to the word "incurred", the Taxpayer had committed itself to an obligation to pay interest, which was fixed and certain, on some date which would be fixed in the future. That date had to be regarded from a legal point of view as certain to occur but unascertainable at present. The interest under the Subordinated Loan Agreement would therefore fall to be paid even though the date of such payment was unknown. The interest was therefore payable.

Whether the interest in question was chargeable to tax

The provisions of Section 16(2)(c) require that, in the circumstances pertaining, the sums payable by way of interest are chargeable to tax under the Ordinance.

It was common ground that any interest paid by the Taxpayer to the parent company prior to 1st April 1989 would have been subject to interest tax under Section 28 of the Ordinance. Section 28 was however repealed effective as of that date. It follows therefore that from that date the conditions of Section 16 could not be satisfied by the Taxpayer and interest in respect of the period following 31st March 1989 could not on any footing be deducted.

Again, as in relation to the word "payable", the argument advanced in the Court below that in order to be deductible, the interest must be chargeable to tax at the time of the relevant assessment of the Taxpayer was not pursued on this appeal.

One of the matters advanced on behalf of the Commissioner was that no tax had in fact been paid whether during the year of assessment or any other year. It was said that

the wording of Section 28 clearly only allowed tax to be charged for any sum which was paid or credited in that year. Unless the sums were paid or credited, no liability for tax would arise under Section 28.

The submission was coupled with the suggestion that the scheme of the Ordinance was that the interest element would be taxable either in the hands of the Taxpayer or in the hands of the person to whom the interest was paid.

The mere repeal of Section 28 without otherwise affecting Section 16 might be said to be equivocal as to the accuracy of this latter argument. Nevertheless, it would appear that the provisions relating to interest tax and the provisions relating to tax deductions are separate. Whereas interest tax may be the relevant tax to consider for the purposes of this case, interest could have fallen to be taxed not only under the interest tax provisions, but those provisions would only have taken effect if profits tax had not been payable.

Looking at the provisions of the Ordinance, there is no clearly definable link between the various deductions which are allowable under Section 16 and the payment of tax in the hands of the recipient of interest that dictates that Section 16(2)(c) must be interpreted as only taking effect if tax is in fact paid.

The word "chargeable" appears throughout the Inland Revenue Ordinance. Its meaning must be interpreted in the context of the section to which it relates. The wording of Section 16(2)(c) requires the consideration of whether the sums which are payable by way of interest are chargeable to tax. Clearly therefore the word "chargeable" in that Section has to be read in conjunction with the word "payable". Given the premise that it is clear that the sum by way of interest may be payable in the future and does not have to be paid or credited in the year of assessment, the Section dictates that what must be looked at is whether the sum of interest is chargeable to tax at some time. Naturally, the payee of the interest may have a different tax year to the taxpayer. In those circumstances, tax may be chargeable and may be payable by the recipient of the interest in a different tax year to that of the taxpayer. Nevertheless, full effect can be given to the present tense used in Section 16(2)(c) namely "are chargeable" if what is looked at is the actual payment and the question is asked "Is that taxable?"

If the interest has not been paid in the year of assessment but is payable in the sense that it will fall to be paid at a future date then, because of the present tense used in Section 16(2)(c), the question must be considered as to whether the sums of interest which are ascertainable are, in the circumstances which prevail for the purposes of assessment, of such a nature that tax would be paid on them.

The answer to the question is that the tax would be paid.

Our attention was drawn for example to Section 51(2) which reads :-

> "Every person chargeable to tax for any year of assessment shall inform the Commissioner in writing that he is so chargeable not later than 4 months after the end of the basis period for that year of assessment unless he has already been required to furnish a return under the provisions of subsection (1)."

It was urged upon us that the interpretation advocated on behalf of the Taxpayer would of necessity raise a different construction for the word "chargeable" to that which would have to be given to Section 51(2) to make it workable. That is however a construction which does not give full effect to the word "payable". Although in the terms of Section 16(2)(c), the interest was payable and chargeable that had to be looked at as of the year of assessment irrespective of whether the interest was in fact paid in that year. Moreover, the words in Section 51(2) are "chargeable to tax for any year of assessment shall inform the Commissioner ... after the end of the basis period for that year "... That Section thus puts a temporal qualification on the word "chargeable".

The deferment of a payment has in the peculiar circumstances of this case led to no tax being paid by the parent company but that was more a quirk of taxation and legislative change rather than any design on the part of the Taxpayer.

In those circumstances, the third question in the Case Stated was correctly answered in the negative. The remaining two questions also fall to be answered in the negative as a necessary corollary of the other answers.

In the circumstances, in my judgment, the Judge below came to the correct decision and the only criticisms that could have been levelled were minor criticisms as to semantics. This appeal should be dismissed.

Finally, the provisions of Section 69(5) of the Ordinance empowers the Court to remit the case to the Board with the opinion of the Court thereon for the Board to revise any assessment as the opinion of the Court may require. In the circumstances, this case should be remitted to the Board so that the assessments for the years 1987/88 and 1988/89 can formally be adjudicated upon on the basis of the interpretation given by the Board, the Court below and this Court.

In view of the fact that this was an unsuccessful appeal, I consider that an Order Nisi should be made that the Appellant should pay the Respondent's costs to be taxed if not agreed.

Leong JA:

I agree. There are three agreements: a Loan Agreement between the Taxpayer and a consortium of banks, a Subordinate Loan Agreement between the Taxpayer and its parent companies and a Share Holders' Subordinate Agreement between the banks, the Taxpayer and the Taxpayer's parent companies. By these agreements the Taxpayer obtained a loan from the banks and a loan from its parent companies. Apart from granting

the loans to the Taxpayer, the effect of these agreements is that although interest accrued on the loan from the parent companies, the Taxpayer was not required to pay the interest or to repay the loan to the parent companies until the Termination Date when the Taxpayer had fully repaid the banks. If the Taxpayer was wound up or dissolved before that time, the parent companies were bound by the agreements not to demand payment of interest or repayment of the loan. The question for consideration is whether the amount of interest accrued on the loan from the parent companies during the basis period for the relevant year of assessment but not paid until the banks were fully repaid may be regarded as "expenses incurred" during that basis period so that the Taxpayer was entitled to deduct that amount under s. 16 of the Inland Revenue Ordinance.

This depends on whether -

a. the interest was "expenses incurred" within the meaning of s.16(1) during the basis period;

b. the interest was "payable" by the Taxpayer;

c. for the purpose of satisfying the conditions in s.16(2), the sums payable by way of interest are "chargeable" to tax.

S.16(1) specifically includes as "expenses" sums payable by way of interest if they are chargeable to tax and other conditions under subsection (2) are satisfied. "Incurred" for the purpose of s.16(1) has been held in the Privy Council case of Lo & Lo v. Commissioner of Inland Revenue (1) as follows:

> "'an expense incurred' is not confined to a disbursement, and must at least include a sum which there is an obligation to pay, that is to say an accrued liability which is undischarged." (At p.72 per Lord Brightman)

This meaning of "incurred" has been followed in Commonwealth authorities in cases involving comparable revenue legislation. There is no reason why this should not be the binding authority in this regard.

Thus, it is necessary to consider what was the Taxpayer's obligation under the agreements in relation to the interest on the loan from the parent companies. No doubt the loan to the Taxpayer bore interest. Clause 2 of the Subordinate Loan Agreement stipulates the rate of interest was 16% compound interest and Clause 3(a) thereof states that interest accrued on the loan, albeit payment was not until the Termination Date. The Commissioner of Inland Revenue argued that the Taxpayer's liability to pay interest was contingent upon repayment of the loan to the bank and if that did not happen the Taxpayer incurred no liability to pay interest. On the other hand it was argued for the Taxpayer that the Taxpayer incurred liability to pay interest when the agreements were made. Only payment was postponed until the banks were repaid and repayment by the Taxpayer was a

matter of commercial certainty in the circumstances of the present case. The liability to pay interest was not a contingent liability.

Lord Oaksey in *Owen v Southern Railway of Peru Ltd.* [2] drew a distinction between contingent liability and payment on a contingency:

> "There is , in my opinion, a fundamental distinction between a contingent liability and a payment dependent on a contingency. When a debt is not paid at the time it is incurred its payment is, of course, contingent upon the solvency of the debtor but the liability is not contingent."

In *Commissioner of Inland Revenue v. Lo & Lo* [1], in the opinion of the Privy Council, a retirement benefit was a sum payable in future and a long service employee had a vested right to his accrued lump sum payment while the employer had an accrued liability for that sum. In *Commissioner of Inland Revenue v. Cosmotron Manufacturing Co. Ltd.*[3], the Privy Council held an employer's obligation to make severance payments on cessation of business was contingent, but the liability to make such payment was incurred as a necessary condition of retaining the services of the employees concerned.

Thus, authorities are clear that a liability to pay does not become contingent because payment is deferred or dependent on a contingency.

For my part, the Taxpayer assumed their obligation to pay interest as a necessary condition for the loans when the agreements were made. The interest accrued as from the time of the loan although interest payment was deferred. The parent companies had an absolute right to interest as when it accrued but it was not to be exercised until the Termination Date. In the meantime, the Taxpayer had an accrued liability to pay interest. The interest on the loan was therefore "incurred" during the relevant basis period.

It was conceded by the Commissioner of Inland Revenue that "payable" does not have any temporal constriction. That means, for the purpose of s.16(1), so long as the interest was incurred in the basis period, it does not matter when it was actually paid. It is not necessary that it should be paid during the same basis period as the interest was incurred. The accrued interest was to be paid by the Taxpayer when they had fully repaid the banks. The interest must be payable by the Taxpayer within the meaning of s 16(1).

On the meaning of chargeable in s.16(2)(c), the subsection requires that "the sums payable by way of interest are chargeable to tax under this Ordinance." S.28 before its repeal in 1989, provided that "interest tax shall be charged for each year of assessment on the recipient of any sum paid or credited to him in that year being interest arising from Hong Kong on any ... loan, advance or other indebtedness." Since its repeal, an interest tax is payable.

The repealed section simply says that a recipient of interest is required to pay interest tax and any sum he receives as interest will be included in the year of assessment in

which he receives the interest. This does not require, in order to make the interest chargeable to tax, the year of assessment of the payer of the interest to be the same year as that of the recipient of the interest on whom interest tax is charged. So long as the recipient of the interest will be charged interest tax when he receives it, the sums payable by way of interest are chargeable to tax. It does not matter for the purpose of claiming a deduction in a year of assessment under s.16 whether the interest has been paid within that year.

In my opinion, there is no temporal restriction on "chargeable" in s.16(2)(c).

In that event, I also agree that the appeal should be dismissed.

(1) [1984] 2 HKTC 34
(2) [1956] 36 TC 602
(3) [1997] HKLR 1161

Nazareth V-P:

I agree with my Lords. Rather than to needlessly repeat what they have already said, I confine myself to recording that in particular I agree in respect of the three central matters i.e.:

(1) The interest in question was "incurred" upon the making of the loan. notwithstanding that it would not, indeed could not, be repaid until the Termination Date.

(2) The interest was "payable" by the taxpayer notwithstanding that it was not required to be paid immediately or in respect of the year of assessment for which the taxpayer claimed a deduction, but only upon a contingency i.e. the Termination Date.

(3) The interest was "chargeable" to tax notwithstanding that it was not charged to tax.

I am satisfied that these conclusions accord with the relevant provisions of the Inland Revenue Ordinance properly construed, that is to say in the way my Lords have construed them.

The appeal is accordingly dismissed with an order nisi that the respondent will have its costs of the appeal.

(G.P. Nazareth)	(Arthur Leong)	(Anthony Rogers)
Vice-President	Justice of Appeal	Justice of Appeal

Mr. Joseph Fok, instructed by Department of Justice for the Appellant

Mr. Robert Kotewall, S.C. & Mr. Stewart K.M. Wong instructed by M/s Mallesons Stephen Jaques for the Respondent