HCIA2/2005

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE

INLAND REVENUE APPEAL NO.2 OF 2005

BETWEEN

ZETA ESTATES LIMITED Appellant

and

COMMISSIONER OF INLAND REVENUE Respondent

Before : Deputy High Court Judge Muttrie in Court
Dates of Hearing : 14 and 15 April 2005
Date of Judgment : 9 May 2005

J U D G M E N T

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1. The appellant, Zeta Estates Limited, appeals by way of Case Stated from a decision of the Inland Revenue Board of Review ("the Board") dated 25 August 2004 whereby the Board dismissed the appellant's appeal from the determination of the Acting Commissioner of Inland Revenue dated 23 October 2003. By that determination, the Commissioner confirmed various assessments or additional assessments for the years 1998/1999 to 2001/02. The effect of the

determination was to uphold the disallowance from deduction of interest expenses which had been incurred by the appellant, from the assessment of its assessable profits for those assessment years.

2. The appellant was a two-project company which dealt with the development of industrial buildings in Ap Lei Chau and had a share in a residential complex at Redhill Peninsula, Tai Tam. It was in fact a joint venture between three property groups. Its issued and fully paid share capital was $990,000, divided into 9,900 shares of $100 each. Its shareholders were Super Queen Investments Limited ("Super Queen") which held 9,600 shares, and Chime Corporation Limited ("Chime"), Harte Estates Limited ("Harte") and Dawna Range Co. Limited ("Dawna"), each of which held 100 shares. The latter three companies, which were the representatives of the three property groups concerned, each held 3,333 shares of the 9,999 issued shares in Super Queen.

3. The Board accepted evidence that the appellant's working capital had been funded by interest free loans from its shareholders as well as bank loans until 1994. From then onwards, its chief sources of finance for working capital, apart from shareholders' equity and trade payables comprised interest free loans from its shareholders. From 1 March 1996 the appellant began paying interest on the shareholders' loans. The reason given was that by then the appellant was receiving a steady stream of rental income.

4. The Board found that by 1993 the two developments had been completed and the appellant had begun earning profits from the sale of units as well as rental income from retained units. Apart from this there had been no other business conducted by the appellant at any time. Prior to 1998 there had been only one declaration of dividend, of some $198 million in 1991. By 28 February 1998 the balance on the appellant's profit and loss account stood at $407,819,437.03 which represented accumulated undistributed profits. It accepted that these profits were returns on investments made by the joint venture partners and retained as working capital for the continuing business of maintaining the appellant's portfolio of rental properties. However by that date, the appellant had completed its developments.

5. On 1 July 1998 the directors of the appellant declared an interim dividend of $40,000.00 per share in the total amount of $396,000,000.00 and on 28 February 1999 they declared a final dividend of $60.00 per share, in the total amount of $594,000.00. The declared dividends were not paid over in cash but, by a series of accounting entries made on the same days, they were, as the Board found, credited to the accounts of the shareholders or their respective associates as loans with interest charged thereon.

6. The Board noted, in finding that no cash payments had been involved, the evidence of the witness Mr Chan that the declaration of dividends meant in effect the withdrawal by the joint venture partners of what had been interest-free finance used by the appellant as working capital; he stated that it therefore became necessary for the appellant to raise fresh working capital in order to continue its operations.

7. The Board made the following conclusions which appear at paragraphs 17-19 of the Case Stated:

> "17. The Board concluded that ' both Mr CHAN and Mr FUNG in their evidence stated that the effect of the transactions (declarations and loans) was to create a liability of the taxpayer and ultimately reduce its profits. Indeed, Mr CHAN confirmed that the purpose of the transactions was to allow the distributions to be made whilst Mr FUNG said that the purpose was to allow shareholders to earn interest income. Therefore, we conclude that the purpose was not to produce the chargeable profits of the taxpayer but to reduce them.'
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> 18. The Board noted that the Appellant in its submissions had argued that the loans made were to replenish its working capital after distribution of the dividends. The Board did not agree with those submissions. The Board considered that there was no evidential basis to support the argument that fresh working capital was needed in the light of the continuing operations of the Appellant having regard to its financial circumstances and, if such working capital was needed, then the directors should not have recommended paying a dividend, since the Appellant was not in a position to pay one.
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> 19. The Board concluded that the loans were obtained for the purpose of paying the dividends and the interest expenses were therefore attributable to the dividend payments — so that they could not be said to have been incurred in the production of the Appellant' s profits."

8. It is the interest charged on the loans which is the subject matter of the dispute. The appellant claims that the interest was deductible from assessable profits under section 16(1)(a) of the Inland Revenue Ordinance, Cap.112 ("IRO"); the Commissioner' s case is that it is not.

9. The relevant parts of section 16, in the version in force at the relevant time, provide as follows:

> "(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 on any money borrowed by him for the purpose of producing such profits.…*
>
> (2) The conditions referred to in subsection (1)(a) are that—
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> (a) the money has been borrowed by a financial institution;
>
> ….
>
> (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;" *(my emphasis)*

10. The question of law raised for the opinion of the Court of First Instance was:

> "Whether, having regard to all the facts found by the Board of Review and on the true construction of the Inland Revenue Ordinance (Cap. 112) and in particular section 16 thereof, the Board of Review was correct in holding that the interest payments made by the Appellant in the years of assessment 1998/1999 to 2001/02 in respect of particular loans to the Appellant made in 1998/1999 were not deductible outgoings or expenses incurred in respect of loan transactions undertaken for the purpose of producing profits chargeable to profits tax?"

11. The appellant applied by way of a summons heard at the beginning of the appeal hearing for the Case Stated to be sent back to the Board for amendment by deletion of paragraph 17, or alternatively by the addition thereto of a transcript of the evidence concerned together with the following additional Question of Law, namely:

> "Whether the Board's conclusion stated in paragraph 17 above is one which is inconsistent with or contradictory to the evidence described therein so that no Board of Review acting judicially and properly instructed in the law could have come to that conclusion?"

12. Having heard argument, I allowed the second alternative, that the additional question of law be added, together with the relevant pages of the transcript, on the basis that there was at least an arguable case that the conclusion was wrong in the light of the evidence. I felt that it would be more prudent to look closely at the conclusions rather than make an immediate decision on the point. It was agreed that the Case Stated should not be sent back for amendment before proceeding with the appeal but rather that it should be amended retrospectively.

13. In the course of argument, Mr Barlow, for the appellant also challenged the Board's conclusions at paragraph 18 of the Case Stated and asked that the further question of law should also apply to the conclusions therein; and I also allowed this application.

14. The basis of these two added questions is that although the appeal is on law only, the appellate court may regard erroneous findings of fact as indicative of an error in point of law. *Per* Lord Radcliffe in *Edwards (Inspector of Taxes) v. Bairstow* [1956] AC 14 at 36:

> "When the case comes before the court it is its duty to examine the determination having regard to its knowledge of the relevant law. If the case contains anything *ex facie* which is bad law and which bears upon the determination, it is, obviously, erroneous in point of law. But, without any such misconception appearing *ex facie*, it may be that the facts found are such that no person acting judicially and properly instructed as to the relevant law could have come to the determination under appeal. In those circumstances, too, the court must intervene. It has no option but to assume that there has been some misconception of the law and that this has been responsible for the determination. So there, too, there has been error in point of law."

15. This approach was endorsed by the Court of Final Appeal in *Kwong Mile Services Ltd v. Commissioner of Inland Revenue* [2004] 3 HKLRD 168, *per* Bokhary PJ:

> "37. In an appeal on law only the appellate court must bear in mind what scope the circumstances provide for reasonable minds to differ as to the conclusion to be drawn from the primary facts found. If the fact-finding tribunal's conclusion is a reasonable one, the appellate court cannot disturb that conclusion even if its own preference is for a contrary conclusion. But if the appellate court regards the contrary conclusion as the true and only reasonable one, the appellate court is duty-bound to substitute the contrary conclusion for the one reached by the fact-finding tribunal. The correct approach for the appellate court is composed essentially of the foregoing three propositions. These propositions complement each other, although the understandable tendency is for those attacking the fact-finding tribunal's conclusion to stress the third one while those defending that conclusion stress the first two."

16. The effect of these judgments is that I must look at the evidence to see whether, as the appellant contends, the Board's conclusions in paragraphs 17 and 18 are such that no person acting judicially and properly instructed as to the relevant law could have come to them. In other words I have to consider whether the conclusions that:

(a) the purpose of the transactions was not to produce the chargeable profits of the taxpayer but to reduce them (paragraph 17); and

(b) there was no evidence that the appellant needed fresh working capital having regard to its financial circumstances and, if it did, it should not have paid the dividends (paragraph 18)

are, to put it shortly, perverse.

17. I have considered the parts of the transcript of evidence to which counsel have referred me. It is correct, as the Board found, that Mr Chan confirmed that the purpose of the transactions was to allow the distributions to be made. He agreed to that proposition under cross-examination; see page 34. In fact he said that the joint venture partners required the dividend and the company had no objection to it; he then agreed that the only "purpose or effect" of the transaction was to enable the distribution to be made; and further that the loan and the declaration were one scheme. There was some argument about the words "purpose or effect". It was suggested that there was confusion between the two, and that the fact that a transaction has an effect does not necessarily infer that the purpose was to arrive at that effect. For my own part I cannot see that the effect could be found without inferring that, in the circumstances of a single transaction, the purpose was the same. In any event there is no evidence from the appellant that its purpose in carrying out the transaction was different from the effect produced.

18. Mr Fung also said under cross-examination that the appellant had decided that it would be to the commercial advantage to the shareholders for the retained profit, or shareholders' funds, to become an interest-bearing financial loan. He agreed that the appellant then incurred a liability and that the only effect on the appellant was that it had greater liabilities than before, although he said that there was no harm to the company, so far as it was viable. He further agreed that the profits would be reduced. I refer in particular to page 42 of the transcript.

19. As to the question of working capital, the Board considered that in the light of the appellant's financial statements and the admissions of Mr Fung under cross-examination that the projects had been completed and that it was "harvest time" from 1995 or 1996. Although there was evidence that the purpose of the loans was in effect immediately to replace the working capital taken away by the distributions it was open to the Board, in my view, to conclude that there was no evidence, or at any rate no credible evidence that that was necessary. The corollary that if the effect was to make the appellant need working capital, it should not have paid the dividends seems to me a tenable one having regard to the law relied on by the Board. I will come back to this later.

20. I conclude that the Board's findings at paragraphs 17 and 18 of the Case Stated were not inconsistent with or contradictory to the evidence. Therefore, they must stand. I return to the original and general Question of Law. Put simply this is whether on the facts and the proper construction of section 16 of the Ordinance the Board was correct in holding that the interest payments were not deductible under that section. The Board's finding as to the purpose of the loans is of course a finding of fact or an inference from facts found by the Board. So ultimately the question comes down to construction of section 16.

21. I have set out the relevant parts of the section above. Its effect is that expenses may be deducted to the extent to which they are incurred in the production of profits. There is no connection in time between the deduction and the profits; the deduction is to be made in the basis period for the year of assessment in which the expenses are incurred but they must be incurred in the production of profits chargeable to tax in any period. Such expenses include interest on any money borrowed for the purpose of producing profits where the provisions of subsection (2) are satisfied; there is now no dispute that those conditions are satisfied, although there seems to have been such a dispute earlier, in respect of some of the interest. So ultimately the question is whether the Board was right to find that the moneys borrowed by the appellant from its shareholders or their associates were not borrowed for the purpose of producing profits.

22. The appellant argues that the Board was in error in accepting the Commissioner's case because that case is based upon an analysis that is wrong in law. In particular, counsel argued that the Commissioner's analysis:

(a) misconstrues the nature in law of dividends;

(b) disregards the fact that, as a matter of law, the dividends were paid;

(c) misconceives the symmetry of the Ordinance's interest expenses provisions;

(d) misconstrues section 16 in that the necessary corollary of the construction is that it contains two different deductions formulae, one for individual proprietors or partnerships and another for corporations; and

(e) infringes the established principle that liability to tax does not depend upon *ex post facto* reconstructions of the taxpayer's management decisions.

23. It is argued that if the appellant had paid the dividends in cash, and the payment had left it without sufficient working capital, so that later it was required to borrow such working capital from a bank, it is unlikely that the Commissioner would have challenged the deductibility of the interest payments on the loans made by the bank. The dividends were properly and legally paid out of undistributed available profits. If the appellant had paid dividends out of each year's net trading profits and had proportionately increased its borrowings to supply of working capital in the following year, it is very unlikely that the Commissioner would have tried to challenge the increased borrowings.

24. It is also argued that the significance of the payment of the dividends by the book entries, for there seems to be no dispute that it was indeed payment, was that once paid the dividends were not recoverable. The debt owing by the company to the shareholders from the time

that the dividend is declared is discharged by payment even though a new debt arises by way of a loan to the company by the shareholder or its associates.

25. These arguments are both, it seems to me, attempts to divorce the payment of the dividends from the loans. This cannot be done because the borrowing and the payment of dividends were one transaction. No doubt, where money is separately borrowed for working capital, that may be regarded as a borrowing made in order to produce profits, but it seems to me that the Board had to look at the true purpose or object of the exercise in the light of this single transaction.

26. The argument on symmetry of the Ordinance's interest expenses provisions seems to be that the Commissioner has disregarded the fact that the payments of interest to the taxpayer's shareholders or associates were necessarily chargeable to tax in the hands of the shareholders under section 15(1)(f) as being "sums received by or accrued to a corporation carrying on a trade, profession or business in Hong Kong by way of interest derived from Hong Kong".

27. It is right that the interest will only be deductible if the purpose of the borrowing element is to produce profit, and the interest is also chargeable to tax under the Ordinance; that is the condition set out in section 16(2)(c). See also *Commissioner of Inland Revenue v. County Shipping Co. Ltd* (1990) 3 HKTC 267 and *Commissioner of Inland Revenue v. National Mutual Centre (HK) Ltd* [1998] 3 HKC 697 which dealt with interest accrued in one tax year and chargeable in another. But this is only a condition which must be fulfilled before interest can be deductible in the hands of the payer. It cannot follow that because interest is chargeable in the hands of the recipient it is necessarily deductible in the hands of the payer. In my view any question of symmetry is irrelevant to the decision of the Commissioner or the Board as to purpose.

28. Then it is argued that the construction applied by the Commissioner and the Board contains two different deductions formulae, one for individual proprietors or partnerships and another for corporations. It is said that the profits of a sole trader or partnership are treated as having come home once they are made. That is so even where the sole trader uses past profits to reduce the amount of borrowed capital that he chooses to employ in his business. No non-corporate trader could be the subject of assessments such as those raised against the appellant.

29. Here, the profits were not used to reduce existing loans of capital. But in any event, the argument seems to me fallacious. If a sole trader, having made profits which he used as working capital, were to use those profits to buy something for himself or meet a personal debt, and then immediately borrowed the same amount as he had spent to replace his working capital, the factual question as to his purpose in making the borrowing would still arise. So it cannot be said that the construction applied here would lead to two different regimes.

30. Lastly it is argued that the Commissioner "second-guessed" the appellant. The latter made a legitimate commercial decision to pay out its undistributed profits as dividends, which it was in a position to do. The wisdom or otherwise of a *bona fide* commercial decision is not a matter for the Commissioner or the Board. The appellant relies on dicta in *CIR v. Swire Pacific Ltd* [1979] HKLR 612 that "the commercial wisdom of the payment is immaterial" and "This is being wise after the event".

31. The argument here was mixed with an attack on the conclusions of the Board in paragraphs 17 and 18, but I have already ruled that these were not perverse and must stand.

32. Mr Wong for the respondent argued that if the profits had been used as working capital, it may in any event have been improper for the appellant's directors to declare the dividends from that working capital, because, as required by section 79F of the Companies Ordinance, in deciding whether or not to declare a dividend, directors must have regard to the needs of the company in terms of the reserves, potential liabilities, and what is required as its working funds or capital. In any event, if the appellant had the working capital in its coffers, the effect of the borrowing was not to enable the company to trade but to enable the distribution, which would not otherwise have been done.

33. It is not necessary to decide whether the declaration of the dividends was proper or even whether it was commercially wise. I do not see that the Commissioner or the Board questioned the commercial wisdom of the appellant's decision. The argument seems to be based mainly on the Board's finding that the appellant did not need to replace working capital or, if it did, should not have paid the dividends in the first place. I think the point is that that finding was made in the context of considering, as the Board had to, the purpose of the borrowing, which is as I have indicated a question of fact.

34. Before the Board, the parties relied on authorities from other jurisdictions, namely South Africa and Australia. The Board in arriving at its decision relied extensively on a decision of the Supreme Court of Appeal of South Africa, *Ticktin Timbers CC v. Commissioner for Inland Revenue* [1999] 4 All SA 192. With regard to an Australian case relied on by the appellant, i.e. *Federal Commissioner of Taxation v Roberts, Federal Commissioner of Taxation v. Smith* (1992) 23 ATR 494, the Board referred to a recent decision of another Board in D4/04 and agreed with the conclusions of that Board on Australian cases cited, including *Roberts & Smith*, that:

> "The wording of the Australian legislation considered in these cases is different from that of our section 16(1)(a); and we are unable to derive any principle of law from either of those cases which can assist the Taxpayer."

35. In his skeleton submissions, Mr Barlow admitted that neither of the foreign cases settled the relevant issue is law, that each was merely a case of a foreign tribunal, acting under

different legislation, attempting to apply fundamental principles to the fact situations before it, and that neither justified nor excused the Board or this court from undertaking the analysis required by this case. However, considerable argument was heard on the relative merits of the South Africa and the Australian approaches to similar fact situations to that which obtains here, in the light of the legislative provisions of those jurisdictions.

36. It is as well to reproduce here paragraph 16 of the Case Stated:

> "16. The Board found the Judgment of Hefer, JA in the decision of the Supreme Court of Appeal of South Africa in **Ticktin Timbers CC v Commissioner for Inland Revenue** … to be of assistance – in particular paragraphs 7-9 and 13 thereof. There the Supreme Court of Appeal of South Africa concluded that the interest paid on the loan, which was raised in order to enable the dividend to be paid, is not an expenditure incurred in the production of income and as such, it is not therefore deductible. The Board considered that the facts in **Ticktin Timbers**…were very similar to the facts before the Board and that the South African deductions provision (Section 11(a) of the Income Tax Act, 58 of 1962) is similar to section 16(1)(c) of the Ordinance, in that it refers to deductions incurred in the production of income and relied on the judgment of Hefer JA of the Supreme Court of Appeal of South Africa which stated as follows:
>
> > '[7] …. the loan was not needed for the appellant's income-producing activities and that the intention was to the crease [the shareholder's] income, and not that of the appellant. The liability for the interest was accordingly not incurred in the production of the latter income….
> >
> > [8] There is another way of looking at the matter which leads to the same result. It is trite that interest paid on a loan which was raised in order to enable a dividend to be paid is not expenditure incurred in the production of income and is therefore not deductible. A company or corporation is not obliged to pay a dividend or make a distribution respectively irrespective of the financial circumstances in which it finds itself. If, after doing so, it will have the resources to enable it to continue its income-earning activities without having to borrow simultaneously an equivalent amount no problem arises. When it will not, but nonetheless pays a dividend or makes a distribution and simultaneously raises a loan in exactly the same amount, it becomes a question of whether or not the purpose of the loan was to enable a dividend to be paid or the distribution to be made or to provide the entity with liquid funds required to enable it to pursue its income-earning activities.

[9] What happened in this case? Simply put it amounts to this. Appellant had enough money in its coffers to finance its income earning operations without borrowing and incurring an obligation to pay interest. It was under no obligation to use that money to make a distribution and its controlling mind (that of [the shareholder]) was well aware that, if it was used for that purpose, it would be necessary to borrow simultaneously an equivalent amount and pay interest on the loan. It is quite clear that the relevant transactions, namely, the making of the distribution on the one hand, and the making of the loan on the other, were not intended to be separate and unconnected transactions. They were plainly interdependent and neither was intended to exist without the other. It is this linkage which, in my mind, is fatal for appellant's case for it shows that the true reason why appellant had to borrow back at interest from the [shareholder] money which it had had in its own coffers and was under no obligation to part with, was because it wanted to make a distribution to the shareholder. What is of moment, as counsel for appellant rightly emphasised, is why appellant incurred the interest-bearing debt. As I have said, the answer seems plain: because it wished to make a distribution to [the shareholder]. The interest was therefore not deductible.

….

[13] There is a clear conceptual distinction between, on the one hand, a case in which a company in good faith and on the strength of inaccurate financial statements furnished by employees declares and pays a dividend, but shortly thereafter learns the true financial position of the company and realises that the dividend should not have been paid and that an equivalent sum will have to be borrowed to finance the company's trading activities and, on the other, a case such as the present. In the present case the purpose of the loan was to enable a distribution to be made to [the shareholder]. Without the loan there would have been no distribution; without the distribution there would have been no loan. In the former case the interest paid will be deductible for the loan was not procured in order to pay the dividend. The fact that the payment of the dividend was the historical cause of the company needing to borrow is irrelevant. The purpose of the borrowing was to finance the company's trading operations after it had parted with its own resources while under the misapprehension that it could afford to do so.' "

37. I think the facts of *Ticktin* are clear enough from the above. The case arose from the Commissioner's refusal to allow the taxpayer, which was a close corporation with only one shareholder, Dr Ticktin, to deduct interest on capital borrowed from him from its income for the purpose of determining its taxable income during the 1985 to 1989 years of assessment. The appellant had declared dividends to Dr Ticktin, but the dividends were not paid out to him; instead they had been credited to his loan account in the books of the corporation. The relevant legislation appears in paragraph 2 of the judgment of Hefer JA:

> "(a) Section 11(a) which allows the deduction of non-capital 'expenditure… actually incurred… in the production of the income' is subject to section 23(g) which (before its amendment during 1992) prohibited the deduction of monies 'not wholly or exclusively laid out or expended for the purposes of trade' ….
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> The combined effect of the two sections is that
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> '[i]f expenditure is incurred in 'the production of income' and 'wholly and exclusively for the purpose of trade' it is deductible, otherwise not.'
>
> (b) The purpose for which the expenditure was incurred is the decisive consideration in the application of section 23(g)…"

38. Mr Barlow describes this formula as more restrictive than our section 16. I do not think there is much in it. Here we have a deduction for income incurred in the production of profits; it is true that there is no similar general provision of "wholly and exclusively for the purpose of trade"; but when we look at interest, what is important is the purpose of the borrowing.

39. The Australian case is interesting because it appears that the court there, and the tax authority, has gone the other way on similar facts. The facts are given in the headnote:

> "In June 1984 a partnership of solicitors borrowed $125,000 from a bank, paying interest on money borrowed and claiming the interest in the books of the partnership as a deduction under section 51(1) of the Income Tax Assessment Act. The loan was used to return to the five then existing partners $25,000 each, so as to reduce the capital contributions required from prospective partners. The taxpayer Smith was a member of the partnership at the time the loan was taken out. The taxpayer Roberts became a partner in May 1987.
>
> [The taxpayers each received an amended assessment increase in taxable income.] In each case the adjustment represented disallowance of deductions claimed by the partnership on interest paid by it on the loan in that tax year, and thus an increase in the amount of partnership income received by the taxpayer."

40. Section 51(1) of the Income Tax Assessment Act provides:

> "All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income."

41. The Administrative Appeals Tribunal upheld the Commissioner. The Federal Court judge allowed the taxpayers' appeals, holding that the money borrowed from the bank constituted part of the capital of the partnership necessary for it to carry on business, and that the use of a loan to enable a return of capital to partners did not prevent the interest payments having been incurred by the partnership in the course of earning assessable income.

42. The Commissioner appealed to the General Division of the Federal Court and argued that the characterisation of the interest was to be determined exclusively by the use to which the monies were put and that use was for the private purposes of the partners. In effect the court upheld the taxpayers' contention that the interest on the borrowings made to replace the payments to the partners was incurred in the income producing activity or in the business activity directed towards the production of income.

43. The Australian Tax Office went further and in its Taxation Ruling TR 95/25 extended the reasoning of the court in the partnership case to tax deductions of companies. Specifically it considered interest to be deductible in the various circumstances including the following:

> "Interest on a borrowing used to fund the payment of a declared dividend to shareholders where the funds representing the dividend are employed as capital or working capital in the business carried on by the company for the purpose of earning assessable income."

44. Mr Barlow complains that the Board distinguished without any meaningful reasons the "clearly superior logic and reasoning of the Federal Court of Australia" despite being made aware of the decision and its adoption by the Australian Tax Office. However as I have indicated, the Board referred to the fact that the Australian legislation is different from that of our section 16(1)(a). The logic and reasoning of a foreign court can only be followed to the extent that that logic and reasoning may be applied to the Hong Kong legislation.

45. Section 51(1) contains two limbs. The outgoings must be incurred in producing the income, or necessarily incurred in carrying on a business for the purpose of producing it. It is perhaps this which has led the court to say that the outgoing must be seen to be "incidental and

relevant to the activity which is directed to the gaining or production of relevant income" (*per* Hill J at page 503, quoting from his own judgment in *Kidston Goldmines Ltd v. FCT*) and to consider that the characterisation of interest borrowed will generally be ascertained by reference to the objective circumstance of the use to which the funds are put, and that the subjective purpose behind the transaction may be but is not necessarily relevant.

46. Hill J at page 504 went on to say this:

> "While acknowledging the usefulness of both the concepts of use to which the funds are put and of subjective purpose, I warned in that case of the danger in substituting for the words of section 51(1) language which does not appear in it. It is a warning to which I adhere. The issue continues to be whether the interest outgoing was incurred in the income producing activity or, in a case falling to be tested and under the second limb, in the business activity which is directed towards the gaining or producing of assessable income. As the cases, including **Kidston**, all show, the characterisation of interest borrowed will generally be ascertained by reference to the objective circumstances to which the borrowed funds are put. However a rigid tracing of funds will not always be necessary or appropriate…
>
> For example, let it be assumed that that there are undrawn partnership distributions available at any time to be called upon by the partners. The partnership borrows from a bank at interest to fund the repayment of one of the partners who has called up the amount owing to him. That partner uses the moneys so received to purchase a house. A tracing approach, if carried beyond the payment to the partner, encourages the argument raised by the Commissioner in the present case that the funds were used for the private purpose of the partner who received them. But that fact will not preclude the deductibility of the outgoing. The funds to be withdrawn in such a case were employed in the partnership business; the borrowing the replaces those funds and the interest incurred on the borrowing will meet the statutory description of interest incurred in the gaining or production by the partnership of assessable income.
>
> In principle, such a case is no different from the borrowing from one bank to repay working capital originally borrowed from another. The character of the refinancing takes on the same character as the original borrowing and gives to the interest incurred the character of a working expense. Both these cases would equally satisfy the second limb of s.51(1). In no sense could the interest outgoing in either case be characterised as private or domestic. Similarly, where monies are originally advanced by a partner to provide working capital for the partnership, interest on a borrowing made to repay these advances will be deductible, irrespective of the use which the partner repaid makes of the funds."

47. The appellant relies particularly on the latter part of this passage as indicating what will happen in a similar situation to that which applies here. As I understand it, the argument is that objectively, the funds borrowed to replace the dividends were put to the use of producing profits as working capital. However, our section 16(1)(a) does not have two limbs and is only concerned that the funds be borrowed for the purpose of producing profits rather than for use in the business generally. I do not think the broader approach taken by the Australian courts can be justified in the light of the words of the provision. I agree with the view the Board took of the Australian cases.

48. It is of course true that the South African approach, like the Australian one, is that of a foreign court dealing with foreign legislation and can only assist to some extent, though, for what it is worth, it seems to me that the South African approach, while based on arguably more restrictive legislation is more suited to the wording of the Hong Kong provision.

49. Ultimately, however, the question is whether having regard to all the facts found by the Board and the true construction of section 16 the Board was correct to hold that the loans were not made for the purpose of producing profits. I have dealt with the argument on the facts; I do not think the findings of fact were perverse so as to show a mistake of law. I do not see that section 16(1)(a) must be construed in such a way as to mean that the purpose of the borrowing can be decided only by the use to which the funds, once borrowed are put without looking at the whole transaction. Accordingly the answer to the question of law posed in the Case Stated is "Yes".

50. The appeal is therefore dismissed with costs (*nisi*) to the respondent, to be taxed if not agreed.

(G.P. Muttrie)
Deputy High Court Judge

Mr Barrie Barlow, instructed by Messrs Ford, Kwan & Co., for the Appellant

Mr Stewart K.M. Wong, instructed by Department of Justice, for the Respondent