CACV 191/2005

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF APPEAL

CIVIL APPEAL NO. 191 OF 2005
(ON APPEAL FROM HCIA NO. 2 OF 2005)

BETWEEN

ZETA ESTATES LIMITED	Appellant
and	
COMMISSIONER OF INLAND REVENUE	Respondent

Before: Hon Le Pichon, Tang JJA and Chu J in Court
Dates of Hearing: 15 and 16 February 2006
Date of Judgment: 6 March 2006

J U D G M E N T

Hon Le Pichon JA:

1. I have had the advantage of reading in draft the judgment of Tang JA. I agree with the reasons he gives in paras. 2 to 37 of his judgment dismissing the appeal and the answers to the

questions in the case stated as proposed in para. 63. As it is unnecessary to consider the second issue given the clear answer to the first issue, for my part, I consider it preferable not to express any views as to the merits of the second issue.

Hon Tang JA:

2. Zeta Estates Limited ("the appellant") has a paid up capital of $990,000.00, divided into 9,900 shares of $100.00 each. The shares were held as follows:

"	No. of Shares Held
Super Queen Investments Limited **("Super Queen")**	9,600
Chime Corporation Limited **("Chime")**	100
Harte Estates Limited **("Harte Estates")**	100
Dawna Range Company Limited **("Dawna Range")**	100
	9,900"

3. The shareholders of Super Queen were Chime, Harte Estates, Dawna Range, each holding 3,333 shares.

4. The appellant built certain industrial buildings in Ap Lei Chau and had a share in a residential complex at Redhill Peninsula, Tai Tam. Since at least from 1996, the appellant' s business was the letting and sale of properties. Essentially, the appellant is the corporate vehicle for a joint venture between 3 real estate developers in these 2 real estate projects.

5. As at 28 February 1998, the appellant had retained profits of about $407 million.

6. 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 million 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 dates, they were, as the Board found, credited to the accounts of the shareholders or their respective associates as loans with interest charged thereon (the new shareholders' loans). It was the appellant' s case that immediately prior to the declaration of dividends the appellant' s business was funded by shareholders' loans of approximately $400 million (the old shareholders' loans), and retained profits of approximately $407 million, and that immediately after the declaration of dividends, the appellant' s business was funded by the old shareholders' loans and the new shareholder' s loans. Mr Barlow, counsel for the appellant, submitted that the new shareholders' loans were required as working capital and that by working capital he referred to circulating capital available which was not invested in fixed assets and therefore available for the day to day business of the company.

7. This is an appeal from the judgment of Deputy Judge Muttrie on a case stated pursuant to section 69 of the Inland Revenue Ordinance, Cap. 112 ("the Ordinance").

8. The appeal concerns section 16(1)(a) of the Ordinance and turns on whether the new shareholders' loans were borrowed "for the purpose of producing such profits". If so, interest on such loans would be deductible.

9. The questions for determination in the case stated as amended are:

> "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?"
>
> and
>
> "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?" (the further question of law)

10. At the hearing, the judge permitted the appellant to challenge the Board's conclusions at para. 18 of the case stated so that the further question of law covered para. 18 as well.

11. Paras. 17 to 19 of the case stated read as follows:

> "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.*'
>
> 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.

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."

12. In my view, these paragraphs raised two distinct questions. The first is whether the new shareholders' loans were needed "in the light of the continuing operations of the appellant having regard to its financial circumstances".

13. Secondly, if so, whether the Board' s conclusion 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" is correct.

14. Turning first to para. 18 of the case stated, the judge understood this to entail a finding that:

> "16(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 …"

The judge went on to say (para. 19 of the judgment):

> "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."

15. Mr Barlow has not contended that that was not what the Board had found in para. 18 of the case stated.

16. So far as the first issue is concerned, Mr Barlow submitted that this conclusion was:

> "… inconsistent with and contradictory to the evidence described (in the case stated) so that no Board of Review acting judicially and properly instructed in the law could have come to those conclusions." (see para. 8 of the Notice of Appeal)

17. The judge has concluded that the findings by the Board "were not inconsistent with or contradictory to the evidence" (at para. 20 of the judgment) and "that these were not perverse and must stand" (at para. 31).

18. Mr Barlow has referred us to the well-known words of Lord Radcliffe in *Edwards (Inspector of Taxes) v Bairstow* [1956] AC 14 at 36 as well as the words of Bokhary PJ in *Kwong Miles Services Ltd v Commissioner of Inland Revenue* [2004] 7 HKCFAR 275 at para. 37, on the basis upon which we can interfere with findings of fact.

19. Mr Barlow submitted that the Board's finding that new working capital was not needed for the business of the appellant was plainly wrong.

20. But since the two real estate projects were completed prior to at least 1996 and that it was an agreed fact that "(the appellant's) principal activities were the letting and sale of properties", it is difficult to see any basis for the suggestion that such large working capital should be required for the day to day business of the appellant. In any event, it is difficult to see how the Board's conclusion could be said to be contradicted by "the true and only reasonable conclusion" per Lord Radcliffe at page 36.

21. Mr Barlow also submitted that the working capital was required because the appellant considered it necessary and that if the Commissioner took issue with the appellant's view, it was for the Commissioner to show otherwise.

22. Mr Barlow submitted that the Commissioner was not entitled to second guess the appellant. He has referred us to *Magna Alloys and Research Pty Ltd v Federal Commissioner of Taxation* [1980] 11 ATR 276, a decision of the Federal Court of New South Wales where Deane and Fisher JJ in their joint judgment said at page 293:

> "For practical purposes and within the limits of reasonable human conduct, it is for the man who is carrying on the business to be the judge of what outgoings are necessarily to be incurred … It is no part of the function of the Act or of those who administer it to dictate to taxpayers in what business they shall engage or how to run their business profitably or economically. 'The Act must operate upon the result of a taxpayer's activities as it finds them' ..."

23. With respect, that must be right but it does not follow that the Board was not entitled to consider whether the new shareholders' loans were indeed required as working capital. No

doubt in deciding the issue it would not dictate to the taxpayer what working capital it should require. However, as Deane and Fisher JJ went on to say at page 294:

> "The subjective purpose or motive of a taxpayer either in incurring an outgoing or in engaging in an activity which attracts liability to make the outgoing is not however irrelevant to the question whether the outgoing was necessarily incurred in carrying on the relevant business… "

24. Indeed, Mr Barlow has not submitted that the mere say-so of a taxpayer is conclusive. Rather he seemed to have submitted that the burden was on the Commissioner to prove that the new shareholders' loans were not required as working capital. I do not agree that the legal burden is on the Commissioner. It is for the appellant to show that the assessments were wrong.

25. Furthermore, there is no clear evidence that the appellant had considered such working capital to be necessary.

26. In his reply, Mr Barlow equated working capital with shareholders' fund, and said that the shareholders' funds were:

> "a. the subscribed capital;
> b. the shareholders' loans; and
> c. the accrued undistributed net profits"

He went on to submit, I believe, that there is evidence that the accrued undistributed net profits were required as working capital and the new shareholders' loans which replaced the retained profits were equally required as working capital.

27. In the transcript of evidence annexed to the case stated on the application of the appellant, this is what Mr Chan Kam-por said (at page 32) on behalf of the appellant during cross-examination:

> "Q But we have actually seen the profits and net cash inflow situation of the company. We can see that it was really making substantial profits every year from its rental business with a substantial net cash inflow from operating activities in millions of dollars, if we are talking about a rather passive business of just deriving rental income. Now, why would not $11 million be quite sufficient for the company's purposes?
>
> A When we look at the required amount of finance, we look at the balance sheet, not the profit and loss account. In the balance sheet we have some $800 odd million of assets to finance, and if it does not come out of retained earnings it has to come out of somewhere.

Q So, are you telling us that the company did not just require the $11 million as working capital, but the entire $396 million?

A Yes.

Q Do you know – and if you do not just tell us – did the directors of Zeta know at the time or did they do any study at the time as to whether, what was the amount of working capital they need to retain in the company around the time they declared the interim dividend?

A I do not know but it is obvious the amount taken out as dividend will have to be replenished, re-financed.

Q So, you are saying that it must have been obvious, are you telling that it must have been obvious to the directors that they need that $396 million as working capital?

A Yes.

Q And no formal study or forecast of any document were prepared?

A No.

Q And it is just because of the balance sheet figures?

A Yes."

28. In re-examination, Mr Chan Kam-por said, at page 36 of the transcript:

"Q Reading that together with the previous page – sorry, page 72, which is a balance sheet – now, you mentioned earlier that one should look at the balance sheet to ascertain the working capital.

A Yes, to ascertain the amount of finance that is required.

Q Yes, yes. What is the relationship between actual cash flow and working capital, Mr Chan?

A It is a difficult question! The cash flow is different from what we call capital because if you look at the retained earning it is determined based on the profit, and it comes, the profit comes from the profit and loss account. The profit and

loss account includes charges of expenses that are non-cash items like depreciation and so on.

Q Yes, yes.

A But at the end of the day profit flow will equal cash flow but over the life of the company, when the company is all wound up, but there is a difference between profit and cash.

Q Yes, and working capital is a balance sheet item, would that be correct?

A Yes.

Q You would agree with that? Whereas cash flow, is that a balance sheet item?

A Cash flow is cash flow. It is not a balance sheet item.

Q No, it is not? So, it is important not to confuse the two?

A Right."

29. Mr Albert Fung Man-yuen, another witness called on behalf of the appellant said in cross-examination, at page 41 of the transcript:

"Q So my question to you then is really, the company was able to pay out or decided to pay out the $407 million because it no longer needed those monies as its working capital. Is that correct?

A No, we can say that because the funds, the shareholders' funds, part of which is the retained profits, is to support the assets which is revenue producing, so we decided that the retained profit is to be, we finance it on interest bearing to interest bearing (sic). Yes."

30. From the evidence quoted above, the witnesses seemed to be saying that because in the balance sheet the appellant had some $800 million of assets to finance, this showed why the shareholders' loans were a continued capital requirement of the appellant. That is different from Mr Barlow's submission to us on the meaning of working capital. See para. 6 above. Nor did Mr Barlow's reply provide a satisfactory answer. The fact that shareholders' fund included shareholders' loans does not necessarily show that the shareholders' loans were required for the appellant's business.

31. Moreover, as Mr Stewart Wong, counsel for the Commissioner, submitted, it was highly unlikely that the dividend of $594,000 declared on 28 February 1999 and which was lent back to the appellant was required for the appellant's business. Since the burden was on the appellant, unless the appellant could show a connection of the shareholders' loans (or part thereof) with the production of profit, the appellant was not entitled to deduct all or any of the interest incurred.

32. Mr Barlow submitted that since the Commissioner has accepted the interest incurred on the old shareholders' loans as deductible under section 16(1)(a), the Commissioner should have allowed deduction for the new shareholders' loans. I do not believe that to be necessarily so. The Commissioner might have been satisfied that the old shareholders' loans were continued to be required for the production of profit but was not satisfied in relation to the new shareholders' loans. Similarly, I derive no assistance from the fact that the Commissioner had not taken issue with an earlier declaration of dividend of $198 million in 1991.

33. On the available evidence, I cannot say that the Board's conclusion that it was not satisfied that the appellant had proved that the new shareholders' loans were required for the business of the appellant as working capital was wrong.

34. Mr Barlow also submitted that the reference to "fresh working capital" in para. 18 showed a misunderstanding of the appellant's case. It is said that the appellant's case was not that fresh working capital was needed but that the same working capital which was required prior to the declaration of dividend continued to be required after the declaration of dividend.

35. I do not believe there was any misunderstanding. I believe that the Board was echoing the evidence of Mr Chan who said:

> "…it therefore became necessary for the appellant to raise fresh working capital in order to continue its operations." (para. 10 of the case stated)

36. As the case stated has recorded, Mr Chan has asserted that the fresh working capital "took the form of additional interest-bearing loans …". It is obvious that in para. 18 the Board was referring to the new shareholders' loans.

37. It follows from the above that I agree with the judge's conclusion on this issue.

38. That is sufficient to dispose of the appeal. However, having regard to the submissions made to us, and the possibility that this matter might go further, I turn to deal with the second issue, namely, if the new shareholders' loans were indeed required as working capital, whether the fact that had the appellant not chosen to declare and pay a dividend, its requirement for working capital would have been satisfied by the retained earnings meant that the interest incurred could not been

said to have been incurred "in the production of profits". This was the Board's conclusion at para. 19 of the case stated.

39. In this part of the case, I assume that the capital requirement of the appellant was funded prior to the declaration of dividends by the retained profits of $407 million as well as the old shareholders' loans of approximately $400 million, and they were used and required for the profit-making activity of the appellant. Further, after the declaration of dividends, the business activity of the appellant continued to require the same amount of capital and that the new shareholders' loans were required to supply that need.

40. Mr Barlow relied on the decision of the Federal Court of Australia in *Federal Commissioner of Taxation v Roberts and Smith* [1992] 23 ATR 494. There the court was concerned with section 51(1) of the Income Tax Assessment Act which provided as follows:

> "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 judge noted that section 51(1) has two limbs, namely:

> "The outgoings must be incurred in producing the income, or necessarily incurred in carrying on a business for the purpose of producing it." (at para. 45)

He thought that section 16(1)(a) has only the first limb, so he felt able to distinguish *Roberts and Smith* on that basis.

42. But in my opinion, the words "incurred … in the production of profits" in section 16(1)(a) covers both limbs of section 51(1). *Commissioner of Inland Revenue v Swire Pacific Ltd* [1979] HKLR 612, a decision of this court, on section 16(1), regarding deductions of payments made to meet strikers' demands, is an example of the second limb.

43. In Australian Tax Law 2005, Woellner, Barkoczy, Murphy and Evans, the learned editors have the following comments on *Roberts and Smith*:

> "*Roberts & Smith* concerned a firm of solicitors. A new partner sought to be admitted to the firm but was unable to pay the amount required to enter into the partnership. To make entry more affordable, the existing partners (one of whom was Mr Smith) decided to reduce the partnership's 'capital account' by $125,000. As the partnership's bank account did not have sufficient funds to pay the $125,000

amount to the partners, the partnership borrowed this amount at interest from the bank. Of the moneys borrowed, $25,000 was paid to Mr Smith and applied for his own purposes. Subsequently, another new partner, Mrs Roberts, was admitted into the partnership. As a partner of the firm, Mrs Roberts (like Mr Smith) was under an obligation to repay the principal and interest in respect of the loan.

The Full Federal Court held that the interest payable by Mrs Roberts was deductible as the outgoing was a financing cost she incurred in entering into the partnership and thus had the requisite connection with her assessable income. However, owing to a lack of findings by the Tribunal (below), the Court was unable to decide whether the interest payable by Mr Smith was deductible. *Hill* J (with whom *Jenkinson* J agreed) indicated that the characterisation of interest will generally be ascertained by reference to the objective circumstances of the use to which the borrowed funds are put. However, his Honour went on to state that a rigid 'tracing of funds' will not always be necessary:

'For example, let it be assumed 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 to 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 of 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 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 … Similarly, where moneys 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.' "

44. *Roberts and Smith*, led to Taxation Ruling TR 95/25 by the Federal Commissioner of Taxation, which extended its application to corporations:

"The ruling goes on to provide that the refinancing principle applies to companies in a similar manner to common law partnerships, ie interest will be deductible on a

borrowing made to fund a repayment of share capital to shareholders where the capital was employed by the company for the purpose of deriving assessable income, but an apportionment may be required where the capital was employed to derive exempt income and no interest will be deductible to the extent that the dividends funded by the borrowings are paid from unrealised profits." (Australian Taxation Law (2005) at p. 711)

45. In my opinion, the following words from the judgment in *Roberts and Smith* at page 504 provide the appropriate approach to the enquiry whether the interests are incurred "in the production of profits":

> "… The funds to be withdrawn in such a case were employed in the partnership business; the borrowing 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."

46. Adopting the same approach and on the assumption stated in para. 39 above, I am of the opinion that the interest incurred as a result of the new shareholders' loans would be deductible under section 16(1)(a).

47. There is support for this view from the judgment of P Chan J (as he then was) in *Wharf Properties Ltd v Commissioner of Inland Revenue* [1995] 1 HKLR 347 at page 369, where he said:

> "… There is nothing to prevent a person who is in possession of a large capital from borrowing from a bank or financial institution to commence or continue his business instead of using his own capital. The purpose of the loan is to use it as capital in his business and that is what he has done. He may have a private motive to serve in borrowing, but that is not important. If by borrowing he can have a tax or other advantage in that he can claim deductions under the provisions of the Ordinance, that is perfectly permissible and is entirely a commercial decision for him."

48. I do not believe the fact that had the dividends not been declared and paid there would have been no reason or need to borrow any money makes any difference.

49. However, both the judge and the Board were influenced by *Ticktin Timbers CC v Commissioner for Inland Revenue* [1999] 4 All SA 192, a decision of the Supreme Court of Appeal in South Africa. The South African legislation under consideration there, section 11(a) of the Income Tax Act 58, 1962, is similar to section 16(1)(a) of the Ordinance, and allows the deduction of non-capital "expenditure ... actually incurred … in the production of the income".

50. In *Ticktin*, dividends were declared but not actually paid to the sole shareholder of a closed corporation. Instead they were credited to the loan account of that member in the books of the closed corporation as an interest-bearing loan in order to finance its day to day operation. The facts are indistinguishable from the present appeal, but in that case, it was not disputed that the loan was required for the "production of the income".

51. The judge cited the following extracts from the judgment of Hefer JA of the Supreme Court of Appeal of South Africa, in his judgment:

> '" [7] … the loan was not needed for the appellant's income-producing activities and that the intention was to increase [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.' "

52. Mr Stewart Wong has referred us to two later decisions from South Africa, namely *Commissioner for South African Revenue Service v Scribante Construction (Pty) Ltd* [2002] 64 SATC 379, a decision of the Supreme Court of Appeal of South Africa, and Income Tax Case No 1764 [2003] 66 SATC 93, a decision of the Cape Tax Court in South Africa. Davis J said in the latter case at page 110:

"For this reason, it would appear that the *Ticktin* judgment can be employed as authority for the proposition that, where a company declares a dividend in circumstances where it would not be possible for that company to make a payment of the declared amount of the dividend other than by way of a simultaneous loan, the irresistible inference to be drawn is that the purpose of the loan was to fund a dividend which could not have been paid in any other way.

By contrast, the judgment in *Scribante* accepts that there can be circumstances where a dividend declaration and a simultaneous conclusion of an agreement of loan with the recipient shareholder for a similar or equivalent amount does not *per se* rule

out the possibility of interest being paid on such loan being considered to be a deductible expense.

Scribante therefore also requires closer attention. When the company declared a dividend, the money held in its call account was surplus to its immediate operational requirements to the extent of R3 373 242. It therefore declared a dividend of R6 573 076 of which amount R3 199 834 was allocated to the shareholder's loan account on the understanding that no interest would be paid whereas the balance which, was similarly credited, bore interest at an agreed rate. The rationale behind this decision appeared to be that to the extent that the company had money which was surplus to 'its immediate operational requirements', it could declare a dividend in that amount without the necessity of concluding a loan agreement with the shareholder. In short, to that extent, the loan was not essential to the declaration of the dividend.

On the facts, if the shareholders withdrew all the interest bearing loans, the company would have been in a solvent condition with sufficient liquidity 'to meet its day to day requirements' at 840D. Heher AJA then went on to observe at 840E. 'An important aspect of the company's business involved the furnishing of contract guarantees (surety bonds) for construction work which it was to undertake. The ability of the company to reflect a substantial cash reserve in its financial statements was of material assistance in readily obtaining the issue of guarantees from financial institutions, thereby sharpening its competitive edge when tendering for contracts and increasing its income potential'.

In his analysis of this evidence, Heher AJA emphasised the uncontested testimony of the company auditor Mr Jacobs, in a passage which I have already cited. Of critical significance to the present dispute is the following extract from that passage: 'Of these considerations, the existence of the surpluses is the decisive factor in the present context. It serves to distinguish all the authorities relied on by counsel for the appellant in which, in all the cases, *the taxpayer was unable to pay a dividend from its own funds* … The evidence was that the cash generated in the course of the company's business would have been sufficient for its operating requirements even if the dividends had not been lent to it at 841G-H; (my emphasis).

Of equal significance is the following *dictum* of Heher AJA 'A company is not to be criticised for declaring and distributing dividends simply because it might otherwise put the funds to use profitably. The declaration of a dividend is a commercial decision regulated by the terms of the company statues and the rules which have been developed in practice …' at 841J-842A.

In seeking to distinguish the decisions in *Giuseppe Brollo, supra* and *Commissioner for Inland Revenue v Elma Investments CC, supra*, Heher AJA said 'Once the declaration of a dividend is not part of a broader scheme but is an independent commercial decision taken in the context of a company which has the resources available for distribution as a dividend, it becomes inapposite to compare the financial strength of the company before the declaration with the position after it borrowed the money in order to determine whether an additional expense or added burden has resulted. In fact, the company was not poorer. As a result of the arrangement it benefited by the loan as it could not have done if the shareholders had used the money or invested it elsewhere as they were fully entitled to do' at 842D-E."

53. Davis J then concluded in page 111:

"Manifestly, the decision in *Scribante* has put paid to an argument that a declaration of a dividend and a simultaneous loan agreement between a recipient shareholder and a company gives rise *per se* to a disallowance of interest paid pursuant to a loan agreement."

54. So the question in South Africa, as in Hong Kong, is under what circumstances would the deduction of interest incurred in such circumstances be permitted. I am of the view that under section 16(1)(a), the answer depended on whether the borrowing was necessary for the business of the taxpayer. In other words, if the retained earnings in respect of which the dividend was declared was surplus to the business requirement of the company and the subsequent borrowing was similarly surplus to the requirement of the company, the interests paid on the borrowing would not be deductible. But if the retained profits were required by the business of the company (that however would not prevent the declaration and payment of dividend, if the company remained in a sound financial footing afterwards), interest on shareholders' loans made to replace the retained profits would be deductible.

55. I believe that an approach modelled on *Ticktin* is likely to lead to highly artificial results. During the argument, I put to Mr Stewart Wong different scenarios to test what answers, according to Mr Wong, *Ticktin* would provide. A few examples will suffice.

56. Suppose, a company borrowed $1,000 million on overdraft to acquire properties, and later sold properties which were acquired at a cost of $200 million for $500 million, and made a profit of $300 million. If $200 million of the $500 million was used to reduce the debt of $1,000 million, and a dividend of $300 million was declared and paid, Mr Wong submitted that the interest on the remaining loan of $800 million would continue to be deductible under section 16(1)(a). However, suppose between the sale at $500 million and the declaration of dividend, all $500 million had been paid into the overdraft account thus reducing it to $500 million. In this case the acquisition of the remaining assets of $800 million would be shown as financed by $500 million of

overdraft and retained profits of $300 million. If a dividend of $300 million was declared at the end of the financial year and payment of the dividend came out of the overdraft account, raising the overdraft to $800 million, Mr Wong submitted, interest on $300 million of the overdraft would not be deductible. That is because the overdraft was incurred:

> "… 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" (see para. 19 case stated)

57. Nor, according to Mr Wong, would it matter whether the loan was owed to a bank or to shareholders. If the initial loan of $1,000 million had come from the shareholders, interest on the loan would continue to be deductible, provided that the $300 million profits were not paid to the shareholders during the year. In other words, if it had been kept with a bank until the payment of the dividends, the interest on $800 million (assuming $200 million had been repaid, though that is not critical) would remain deductible. That is because the loans were originally borrowed for the business of the company, namely, the acquisition of the profit making assets.

58. Mr Wong further submitted that suppose the acquisition was funded by a bank loan, but during the year, the bank had required say $500 million to be repaid and was repaid out of the proceeds of sale of $500 million. Then, if at the end of the year, a new loan of $800 million could be arranged, and $300 million used to pay dividends then interest on the entire $800 million would continue to be deductible. That is because the repayment of the loan was not voluntary. The distinction is based on the fact that in *Roberts and Smith*, the partners were entitled to demand the repayment of the partnership loans, whereas shareholders are not entitled to demand the payment of dividends. Even so, it is difficult to understand why the fact that the repayment of the bank loan was involuntary could override the fact that when the dividends were declared, it was done voluntarily. It may be that Mr Wong was influenced by the conceptual distinction alluded to by Hefer JA in para. 13 of his judgment. With respect, deductibility should not depend on whether a mistake was made at the time dividends were declared. It should depend on whether the borrowings were needed for the continued business (which would include existing and new business) of the company.

59. The language of section 16(1)(a) does not require me to accept an approach which can produce such artificial distinctions. I prefer the Australian approach which I have summarised in para. 45 above.

60. Mr Wong submitted that *Roberts and Smith* is suspect because it cannot stand with *The Federal Commissioner of Taxation v Munro* [1926] 38 CLR 153.

61. *Munro* was concerned with section 23(1) of the Income Tax Assessment Act 1922-1924, which provided that from the total assessable income of a taxpayer there should be deducted all losses and outgoings including, among other things, interest actually incurred in gaining

or producing the assessable income. The taxpayer had certain rental income property. The taxpayer borrowed money for other investments, secured by a mortgage of the rental property. The taxpayer argued that since unless interest on the loan thus secured was paid, he would lose the rental property and hence the rental income, the interest was deductible because it was "actually incurred in gaining or producing the assessable income". This is what Knox CJ said at page 171:

> "… If no mortgage had been given to secure the payment of principal and interest to the bank, the liability of the respondent would have been no less, but it was not suggested at the Bar that in that case he would have been entitled to any deduction in respect of interest paid by him. It is said, however, that, because the respondent gave a mortgage over his rent-producing property to secure payment of principal and interest to the bank, the payment of interest was necessary in order to enable him to receive the rents of the property and the amount paid was therefore wholly expended for the production of assessable income. Indeed, it was contended that, whenever money was borrowed by a taxpayer on the security of a rent-producing property, the interest paid under the mortgage should be deducted from his assessable income, irrespective of the purpose to which or the manner in which the money borrowed was applied.
>
> In this case the assessable income of the taxpayer was in no way referable to the transaction with the bank out of which the liability to pay interest arose, and the loan by the Bank was in no way instrumental in or conducive to the production of the assessable income or that part of it which consisted of the rents of the freehold property. The respondent was, before the mortgage was given, entitled to the whole of these rents, and he did not gain them nor were they produced in consequence of the payment of interest. The interest was paid, not for the purpose of gaining or producing assessable income of the taxpayer, but for the purpose of satisfying *pro tanto* a debt which the taxpayer had incurred with a view, not to the production of his assessable income, but to the production of income by the company for the benefit of its shareholders. The debt having been incurred for a purpose wholly unconnected with the production of assessable income of the respondent, I think it impossible to say that the interest paid on the amount of the debt was money wholly and exclusively laid out or expended for the production of his assessable income."

62. I am not surprised that the taxpayer's case was rejected. Otherwise, as Mr Stewart Wong submitted, a taxpayer who mortgaged his rental property to pay school fees could deduct the interest from the rental income. I do not believe *Munro* is authority for any principle of wider application. It was not regarded by the Federal Court of Appeal as an impediment to their decision in *Roberts and Smith.* As noted, the correctness of that decision has been accepted by Taxation Ruling TR 95/25 and extended to corporations.

63. For the above reasons, the answer I would give to the first question in the case stated is yes. As for the further question, I do not regard that question as it relates to para. 17 to be relevant to the outcome of the first question. Insofar as it relates to para. 18, the conclusion of fact, namely, that there was no evidence, or at any rate no credible evidence that (the new shareholders' loans) was necessary for the business of the appellant, is correct. So the answer to the second question, as it applies to paragraph 18 of the case stated, is no.

64. I would dismiss the appeal, with a costs order *nisi* in favour of the respondent. Such costs to be taxed if not agreed.

Hon Chu J:

65. I agree for the reasons given by Tang JA that the appeal should be dismissed.

Hon Le Pichon JA:

66. Accordingly, this appeal is dismissed. There will be a costs order *nisi* that the costs of this appeal be to the respondent.

(Doreen Le Pichon) Justice of Appeal	(Robert Tang) Justice of Appeal	(Carlye Chu) Judge of the Court of First Instance

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.