FACV No. 15 of 2006

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

FINAL APPEAL NO. 15 OF 2006 (CIVIL)
(ON APPEAL FROM CACV NO. 191 OF 2005)

BETWEEN

	ZETA ESTATES LIMITED	Appellant
	and	
	COMMISSIONER OF INLAND REVENUE	Respondent

Court : Mr Justice Bokhary PJ, Mr Justice Chan PJ, Mr Justice Ribeiro PJ, Mr Justice Mortimer NPJ and Lord Scott of Foscote NPJ
Date of Hearing : 6 March 2007
Date of Judgment : 29 March 2007

J U D G M E N T

Mr Justice Bokhary PJ :

1. I agree with the judgment of Lord Scott of Foscote NPJ.

Mr Justice Chan PJ :

2. I agree with the judgment of Lord Scott of Foscote NPJ.

Mr Justice Ribeiro PJ :

3. I agree with the judgment of Lord Scott of Foscote NPJ.

Mr Justice Mortimer NPJ :

4. I agree with the judgment of Lord Scott of Foscote NPJ.

Lord Scott of Foscote NPJ :

5. This is a tax appeal. The appellant, Zeta Estates Limited, is a joint venture company incorporated in Hong Kong in 1970 for the purpose of purchasing and developing Hong Kong real estate. There are three joint venturers, namely, Chime Corporation Limited, Harte Estates Limited and Dawna Range Company Limited. Each of the joint venturers held, either directly or indirectly, 3,300 fully paid-up shares of $100 each in Zeta. The equity capital invested in Zeta was, therefore, $990,000. In addition, however, the three joint venturers made loans to Zeta and, until 1994, bank loans, also, were obtained. The loans from the shareholders were, initially, interest free. The capital thus obtained was deployed in purchasing and developing for sale or rental Hong Kong properties. By March 1996, the bank loans had been repaid and a steady stream of rental income that enabled Zeta to commence paying interest on the shareholders' loans was being received.

6. In addition to the rental income that Zeta was receiving, profits were earned also from sales and, in 1991, Zeta declared and paid dividends to its shareholders. The evidence does not disclose how these dividend payments were financed. Dividends were not declared again until 1998 and the following years. It is in relation to the dividends declared in 1998 that the tax issue now before this Court has arisen. The same issue arises, however, in respect of dividends declared in 1999 and in some of the following years and this Court's decision regarding the 1998 dividends will settle the same issue in relation to the subsequent years' dividends.

7. The principal issue for decision can be very shortly stated. After the 1998 dividends had been declared, no money was actually paid to the shareholders in discharge of Zeta's liability that the declaration of the dividends had created. Instead the amount of the dividend payable to each shareholder was treated as a loan at a commercial rate of interest by that shareholder to Zeta. Zeta's liability to pay the dividend was treated as discharged by the loan. Interest was paid on the loan accordingly. In its tax return for the 1998/1999 year of assessment, Zeta sought to deduct from its assessable profits the interest it had paid on these new shareholders' loans. The Commissioner disallowed the deduction. Zeta appealed to the Board of Review but the Board

upheld the Commissioner's ruling. So, on a case stated for the opinion of the Court of First Instance, did Deputy High Court Judge Muttrie. The Court of Appeal dismissed Zeta's appeal from the Deputy Judge's judgment but leave for a further appeal was given and the issue must now be finally laid to rest by this Court. The issue is whether the interest paid by Zeta on the shareholders' loans attributable to the payment, or the discharge of Zeta's liability to pay, the 1998/1999 dividends is deductible from Zeta's assessable income.

8. The issue turns on the construction of and the effect to be given to s.16 of the Inland Revenue Ordinance, Cap. 112. The section provides, so far as is relevant for the purposes of this case, 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 condition for the application of this paragraph is satisfied under subsection (2), … , sums payable by such person by way of interest on any money borrowed by him for the purpose of producing such profits, …
>
> …"

It is common ground that the subsection (2) "condition" referred to in para.(a) is satisfied. The question, therefore, is whether it can be said that the borrowings by Zeta from its shareholders, made for the purpose of discharging Zeta's liability to pay the 1998/1999 dividends, were borrowings "… for the purpose of producing profits."

9. The details of Zeta's balance sheet and profit and loss account for the year ended 28 February 1999 are, in my opinion, highly important. They were in evidence before the Board of Review and some of the details are referred to in the case stated. None is in dispute. The accounts show that dividends of a little under $400 million were declared. At the commencement of the year (i.e. 1 March 1998), Zeta's net assets stood at nearly $863 million of which nearly $408 million represented accumulated profits and over $454 million represented shareholders' unsecured loans. The $863 million included net current assets of just over $854 million ($892 million odd current assets less $38 million odd current liabilities). The $892 million odd current assets included real estate valued at cost at $840.5 million or thereabouts (see Note 4 to the accounts). These figures show a company with very substantial net assets, very substantial accumulated profits but very little liquidity. Zeta was highly profitable but highly illiquid. It could not have paid the 1998/1999 dividends of $400 million otherwise than by selling off some part of its profit-earning real estate

portfolio, which would have reduced its income, or by additional borrowing, the interest on which would reduce its income. A reduction of income attributable to the declaration of the dividends was inevitable.

10. The arrangement agreed to by the joint venturers, each of which was represented on Zeta's board of directors, was that the payment of the 1998/1999 dividends should be financed by means of shareholders' loans. Each shareholder was to leave the amount of its dividend with Zeta as an interest bearing loan. The arrangement was implemented and, accordingly, Zeta's balance sheet as at 28 February 1999 shows unsecured loans from shareholders at $853 million odd (an increase of about $400 million over the 28 February 1998 figure) and the profit and loss account for the year ended 28 February 1999 shows "interest charges on unsecured loans wholly repayable within 5 years" rising from $41.36 million odd for the previous year to $84.5 million odd for 1998/1999. The bulk, if not the whole, of this increase must have been attributable to the new shareholders' loans by means of which the 1998/1999 dividends were treated as paid.

11. The Board's case stated, as drafted, asked :

> "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 respect of the new shareholders' loans] were not deductible outgoings or expenses incurred in respect of loan transactions undertaken for the purpose of producing profits chargeable to profits tax?"

Two additional questions were added by Deputy Judge Muttrie in the course of the hearing of the appeal to the Court of First Instance. It is not necessary to set out the text of those additional questions the purpose and effect of which was to enable the appellate court to regard erroneous findings of fact by the Board as indicative of an error of law (see para.14 of the judge's judgment and his references to *Edwards v. Bairstow* [1956] AC 14 at 36 and *Kwong Mile Services Ltd v. Commissioner of Inland Revenue* (2004) 7 HKCFAR 275 at para.37).

The Board's findings of fact

12. The findings of fact made by the Board, as set out in the case stated, are important. Some of them are challenged by Zeta but it is accepted that an appellate court cannot disturb the Board's factual conclusions unless the contrary conclusion contended for is the only reasonable one that could be reached on a proper consideration of the primary facts (see Bokhary PJ, in the *Kwong Mile Services* case at para.37). The Board's factual conclusions are to be found in paras 17, 18 and 19 of the case stated but some of the Board's comments on the primary facts made earlier in the case stated illuminate the factual conclusions and deserve mention.

13. In para.7(b) of the case stated, the Board noted that by 1993 Zeta had completed

two property developments and had commenced earning profits from rentals and sales of units and, in para.7(d), referred to Zeta' s "assertion" that following the completion of the developments, the accumulated profits – $407 million odd by 1 March 1998 and on the basis of which the 1998 dividends had been declared – "had been retained as working capital for the appellant' s continuing business of maintaining its portfolio of rental properties". Zeta' s "assertion" is shown by the 1998/1999 accounts to be true. It is plain beyond any doubt or contradiction that Zeta' s working capital was tied up in its property portfolio. But the Board commented "However, by that date [i.e.1998] the appellant had completed the developments". An inference capable of being drawn from that comment is that the Board did not regard the capital tied up in the property portfolio once the developments had been completed as "working capital". It is consistent with that inference that the Board, in para.18 of the case stated, said this:

> "… 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."

14. In para.17, the Board concluded that :

> "… the effect of the transactions (declarations and loans) was to create a liability of the taxpayer and ultimately reduce its profits."

and that :

> "… the purpose [of the transactions] was not to produce the chargeable profits of the taxpayer but to reduce them."

And in para.19 the Board expressed the 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.*" (emphasis added)

15. The Board' s factual conclusions in these three paragraphs were, broadly speaking, accepted both in the judgment of Deputy Judge Muttrie in the Court of First Instance and in the judgment of Tang JA, with whose judgment Le Pichon JA and Chu J agreed, in the Court of Appeal (see para.20 of Deputy Judge Muttrie' s judgment and paras 33 to 37 of Tang JA' s judgment). The Board' s factual conclusions, in my respectful opinion, indicate some misunderstanding about the concept of "working capital" and its relevance to the tax issue which the Board had to answer. Deputy Judge Muttrie, in para.21 of his judgment, said, correctly, that :

> "… 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."

"Working capital" is a term used to describe the capital employed in a business in order to produce the profits of the business. Working capital was used by Zeta to purchase and then to develop its properties. Once the acquisition and development of the properties had been completed, the "working capital" expended by Zeta to arrive at that profit-earning stage did not disappear. The developed properties represented the "working capital". And subsequent expenditure by Zeta in order to retain, and maintain, the properties as profit-earning assets would be expenditure "for the purpose of producing such profits" (see s.16(1)(a)). The Board appears, in paras 17 and 18 of the case stated, to have concentrated on the question whether "fresh working capital was *needed* …" (emphasis added). This was the wrong question. Whether fresh working capital was needed, and whether or not a dividend should be declared out of accumulated net profits, were questions for the commercial judgment of the directors. They were no possible concern of the Commissioner, or the Board of Review, or the courts. The question relevant to Zeta's tax liability and to the deductibility of the interest paid on the borrowings to raise the fresh working capital is *why* the capital was raised. If the fresh capital was raised by Zeta in order to retain, or maintain, its profit-earning assets the interest on the borrowings would, in my opinion, in principle be deductible under s.16(1)(a) whether or not the Commissioner or the Board, or anyone else, approves of the commercial judgment of the directors in deciding to raise the fresh working capital.

16. Section 16(1)(a) refers to "… the purpose of *producing* … profits" (emphasis added). However, the word "producing" should not, in my opinion, be given a restricted literal meaning. If the purpose of the borrowing is to maintain an existing profit producing capacity, the requirement of the statutory provision would, in my opinion, be satisfied. Take, for example, a case where a company with considerable assets but little liquidity incurs a trading liability and, in order to avoid selling of some of its profit-earning assets in order to fund the payment of the debt, persuades the trade creditor to leave the debt outstanding on terms that monthly interest at a generous rate will be paid until payment of the debt. Would the Commissioner challenge the deductibility of the interest under s.16(1)(a)? It might be argued that what would be, in effect, a borrowing on interest terms of the amount of the debt was not a borrowing to *produce* profits. It plainly would be, however, a borrowing to *maintain* profits, to prevent the reduction of profits in consequence of a forced sale of profit-earning assets. At the opening of this appeal I put this example, with others, to counsel and asked whether the interest would be deductible. Mr Ambrose Ho SC, counsel for the Revenue, did not, in his submissions to the Court, indicate what the Revenue's answer would be. Another example would be the case of a company, similarly asset rich but illiquid, which had incurred a liability to one of its employees who had been injured at work. Suppose the employee were to recover a damages award substantially in excess of the company's insurance cover and that the company were faced with the alternative either of selling sufficient of its profit-earning assets to meet the debt or borrowing the requisite sum on interest terms from its shareholders. The

company chooses to borrow from its shareholders. Would the interest payable to the shareholders be deductible under s.16(1)(a)? The borrowing would have been made for the purpose of paying the damages but, also, in order to avoid having to sell profit-earning assets. In my opinion, unless the reference to "borrowed … for the purpose …" in s.16(1)(a) must be construed as "borrowed *wholly and exclusively* for the purpose …" – a possible construction that I must consider later – the statutory requirement that the borrowing be "for the purpose of producing … profits" would be satisfied. A third example is that of a company that takes out loans to repay existing borrowings. It is accepted that interest paid on borrowings made for the purpose of producing profits are deductible under s.16(1)(a). Suppose that borrowings from a bank are made in order to assist the company to establish itself as a profit-earning enterprise. And suppose after the company has established itself and the bank is pressing for repayment, the company agrees with its shareholders that they will make loans to enable the company to repay the bank. How could it be sensibly contended that interest on these shareholders' loans would not, in principle, be deductible under s.16(1)(a)? This was another example I put to counsel, but here, too, Mr Ho did not indicate what the Revenue's response would be.

17. These examples indicate, in my opinion, that if it is apparent that the purpose of the borrowing in question is to maintain the profit-earning capacity of the company by avoiding the need to sell profit-earning assets, or, as the case might be, to preserve in some other way the profit-earning capacity of the assets, the borrowing should be regarded – subject to the point of construction I have already mentioned – as satisfying the s.16(1)(a) requirement that the borrowing be for the purpose of producing profits, and the interest on the borrowing should be deductible accordingly.

18. The Board's factual conclusion in para.17 that the declaration of the dividend and the loans constituted a single transaction the purpose of which was not to produce profits but to reduce them was based, in my opinion, on a misconceived analysis of the primary facts. It was reasonable for the Board to regard the dividend declaration and the loans as a single transaction in the sense that but for the dividend declaration the loans would not have been needed. And, of course, Zeta's witnesses, Mr Chan and Mr Fung, accepted in their evidence that that was so. But it was not permissible, in my opinion, for the Board to try to attribute a single purpose to that composite transaction. The purpose of the declaration of dividends was to return some of Zeta's accumulated net profit to the shareholders. That that was the purpose is too obvious to require to be supported by evidence. The purpose of the loans was to fund the payment of the dividends. That, too, was too obvious to require to be established by evidence. But the Board's conclusion in para.17 that the purpose of the composite transaction was not to produce profits but to reduce them is unacceptable. It would have been fair, and obvious, to say that the *effect* of the composite transaction was to reduce profits, but that was because the effect of the dividend declaration was to impose a liability on Zeta, a debt enforceable against Zeta by the shareholders, that had to be funded in one way or another. The liability arose out of a normal and permissible exercise by the directors of their powers of management of Zeta. I have already said, and repeat, that the directors' decision to declare the dividend was a decision the propriety of which is not open to

challenge by the Revenue.

19. The effect of the directors' decision to declare the dividend was, given the illiquid state of Zeta, to produce a need for the payment of the dividend to be funded. Zeta had only two ways of doing so. Either Zeta would have to sell sufficient of its profit-earning assets to pay the dividends, i.e. to reduce part of its working capital into liquid form and use that part to pay the dividends, or Zeta would have to borrow a sufficient sum to pay the dividends, i.e. to raise additional working capital for that purpose. That these were Zeta's only options is apparent from its 1998/1999 accounts. It chose the borrowing option, i.e. it chose to fund the payment of the dividend by raising fresh working capital rather than by selling profit-earning assets, using the proceeds of sale and thereby reducing its working capital. The Board's conclusion in para.18 that "there was no evidential basis to support the argument that fresh working capital was needed …" must either have been based on a fairly fundamental misunderstanding of Zeta's 1998/1999 accounts or on the misconceived notion that if the dividends could not be paid without either selling assets or borrowing the dividends ought not to have been declared.

20. In my opinion, the Board's para.18 conclusion that there was no evidential basis that Zeta needed fresh working capital was a conclusion to which no tribunal properly directing itself could have come.

21. There remains the important question of law to which I have already referred, namely, in order for interest on borrowing to be deductible under s.16(1)(a), is it necessary for the borrowing to have been raised *wholly and exclusively* for the purpose of producing profits? The view of the Board seems to have been that this "wholly and exclusively" requirement should be read into s.16(1)(a). I so assume from para.19 of the case stated where the Board say that because the new shareholders' loans had been obtained for the purpose of paying the dividends, they therefore "could not be said to have been incurred in the production of profits".

22. A particular transaction may have different purposes at different levels. A parent pays school fees to his or her child's school for the purpose of discharging a debt incurred to the school, but also for the purpose of having the child educated and, sometimes, for the purpose of obeying a court order to pay the fees. In the example of the loan incurred to pay a trade debt (see para.16 above), the immediate purpose of taking out the loan would be to pay the debt but an underlying purpose would be to avoid having to sell profit-earning assets, or, it may be, to avoid legal proceedings being taken for recovery of the debt or the assets being taken in execution of a judgment for payment of the debt. If a borrowing taken out to acquire profit-earning assets is called in, a new borrowing taken out to discharge the previous borrowing may also be said to be taken out for the purpose of avoiding a sale of the profit-earning assets. Any number of similar examples can be constructed. It is altogether too simplistic to say that because a loan is taken out for one purpose it cannot be regarded as taken out for some other underlying purpose or purposes. It must be kept in mind, however, that the question whether the Board's approach in para.18 was right depends upon the construction of s.16(1)(a).

23. In summary, therefore, the conclusion, based on the contents of the 1998/1999 accounts, that the $400 million odd raised by the new shareholders' loans represented capital borrowed for the purpose of meeting Zeta's liability to pay the declared dividends and in order to avoid raising that sum by a sale of some of Zeta's profit-earning assets, is, in my opinion, inescapable. The borrowing was incurred in order to enable Zeta to retain its profit-earning assets and accordingly to maintain its profits. I regard the factual conclusions reached by the Board, to the extent that they are inconsistent with the conclusions above-stated, as being conclusions not open to be reached on the evidence before the Board. I turn now to the issue of construction.

24. Before the Board, before Deputy Judge Muttrie and before the Court of Appeal South African and Australian case law was relied on, the South African case law by the Revenue, the Australian case law by Zeta. The leading South African case was *Ticktin Timbers CC v. Commissioner for Inland Revenue* [1999] (4) SA 939, a case in the South African Supreme Court of Appeal. The issue, like that in the present case, was whether interest, paid by the taxpayer company on a dividend that had been declared but retained in the taxpayer's business as an interest bearing loan in order to finance the taxpayer's business operations, could be deducted from its assessable income for tax purposes. Hefer JA, with whose judgment the other four members of the court agreed, held it could not. In paras 7 and 8 of his judgment Hefer JA explained why :

> "7. … The liability for the interest was … not incurred in the production of the [taxpayer company's] income. But, even if it was, the loan plainly served a dual purpose, one of which had no bearing on [the company's] trade. The deduction of the interest was thus prohibited by s.23(g) …
>
> 8. … 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 ..."

Section 23(g) of South Africa's Income Tax Act 58 of 1962, to which Hefer JA had referred, prohibits the deduction of expenditure "not wholly or exclusively laid out or expended for the purposes of trade" (see para.2(a) of Hefer JA's judgment). Section 16 of the Hong Kong statute has no corresponding prohibition. So a finding that the purpose of the loan was to enable declared dividends to be paid would not necessarily be fatal in Hong Kong.

25. The Australian statute, like Hong Kong's s.16, has no "wholly or exclusively … for the purposes of trade …" requirement. Under s.51(1) of Australia's Income Tax Assessment Act 1936 outgoings are deductible –

> "… 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 …"

Federal Commissioner of Taxation v. Roberts and *Federal Commissioner of Taxation v. Smith* (1992) 23 ATR 494 were conjoined appeals raising the same issue. The taxpayers, Roberts and Smith, had been partners in a five-partner firm of solicitors that had borrowed $125,000 from a bank and used the money to return $25,000 to each partner so as to reduce the capital contribution required from prospective incoming partners. The issue was whether the interest on the loan was deductible under s.51(1). Taxpayer Smith had been a partner when the loan had been taken out. Taxpayer Roberts was an incoming partner who had joined the firm after the loan had been taken out. The Federal Court underlined the importance of identifying "the essential character of the expenditure" in order to determine "whether it is in truth an outgoing incurred in gaining or producing the assessable income or necessarily incurred in carrying on a business having the purpose of gaining or producing assessable income" (per Hill J at 501). And at 504 Hill J described the issue as being "whether the interest outgoing was incurred *in* the income producing activity or … *in* the business activity which is directed towards the gaining or producing of assessable income." He said that "the characterisation of interest borrowed will generally be ascertained by reference to the objective circumstances of the use to which the borrowed funds were put" and then gave an example of what he had in mind, an example particularly pertinent to the issue in the present case :

> "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 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 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.
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> 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 …"

The above cited passage was cited by Deputy Judge Muttrie but distinguished on the ground that Hong Kong' s s.16(1)(a), unlike the Australian s.51(1), did not have two limbs and was "only concerned that the funds be borrowed for the purpose of producing profits rather than for use in the business generally" (para.47 of the judge' s judgment). The judge expressed a preference for the South African approach rather than the Australian. The approach of the former, he said, "while based on arguably more restrictive legislation is more suited to the wording of the Hong Kong

provision". My own preference would be the reverse. The South African statutory requirement that the borrowing be "wholly and exclusively" for the purpose of producing profits was fundamental to Hefer JA's conclusion but is a requirement absent from the corresponding Hong Kong and Australian statutory provisions.

26. In the Court of Appeal, Tang JA disagreed with the basis on which Deputy Judge Muttrie had distinguished the *Roberts and Smith* case. He (Tang JA) said that in his opinion the s.16(1) words "incurred in the production of profits" covered both limbs of the Australian s.51(1) (see para.42 of Tang JA's judgment). He said that, on the hypothetical assumption

> "… 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 [that] they were used and required for the profit-making activity of the appellant …" (para.39 of his judgment),

he would be of the opinion that the interest paid on the new shareholders' loans would be deductible under s.16(1)(a) (see his para.46). Tang JA had already come to a conclusion on the facts that was inconsistent with the hypothetical assumption expressed in his para.39. However, for the reasons I have already expressed, I think his conclusion on the facts to have been wrong and, consequently, that his para.39 assumption was correct and well-founded.

27. In para.54 Tang JA went on to expand and explain his para.46 conclusion in terms with which I am in respectful agreement. He said this :

> "So the question … is under what circumstances would the deduction of interest [payable on a loan taken out in order to pay a dividend] be permitted. I am of the view that under section 16(1)(a), the answer depended on whether the borrowing was necessary for the [purposes of 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."

In the case, as postulated by the learned Justice of Appeal, where the interest would be deductible, the new shareholders' loans would represent additional working capital for the company, needed to replace the working capital by means of which the dividends had been paid.

28. Tang JA's para.39 assumption, on the basis of which he had postulated the case in which the interest payments would be deductible, is made good, in my opinion, by the primary facts

of this case and, in particular, by Zeta's 1998/1999 accounts. The accounts show that Zeta's retained earnings in respect of which the dividends were declared were not surplus to Zeta's requirements but were tied up in Zeta's profit-earning assets. The accounts show that new loans were the only means by which the dividends could be paid without selling some of the profit-earning assets. All the conditions for deductibility of the interest on the new loans, as set by Tang JA in his para.54, seem to me to be shown by the accounts to have been met. So I am left in some puzzlement why it was that the learned Justice of Appeal felt constrained to accept that Zeta had not produced evidence to show that the new shareholders' loans were indeed required as additional working capital for its business (see his para.33).

29. It is interesting to notice that Volume 2 of Rulings and Guidelines, promulgated by the Australian Federal tax authorities, contains a ruling and guidance particularly directed to the deductions permitted under s.51(1) of the Income Tax Assessment Act 1936 following upon the decision in the *Roberts and Smith* case. Under the sub-heading "Companies", paras 12, 13 and, particularly, 15 are, for present purposes, pertinent. They contain the following passages :

> "12. In determining whether interest is deductible, regard must be given to the commercial context in which the company borrowed the relevant funds …
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> 13. … interest on a borrowing by a company may be deductible where the borrowing is used to fund a repayment of share capital to the shareholders in circumstances where the repaid capital was employed as capital or working capital in the business carried on by the company for the purpose of deriving assessable income…
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> …
>
> 15. Similarly, interest on a borrowing by a company is likely to be deductible where the borrowing is used to fund the payment of a declared dividend to the shareholders in circumstances where the funds representing the declared dividend are employed as capital or working capital in the business carried on by the company for the purpose of deriving assessable income. In circumstances where the liability to pay the dividend reduces the amount to the credit of the unappropriated profits account and the reduction is replaced in the company's accounts by the loan, there will usually be a nexus between the interest expense and the carrying on of a business for the purpose of deriving assessable income."

30. Paragraph 15 of the ruling expresses much the same idea as para.54 of Tang JA's judgment with which I have already expressed my agreement. Paragraph 15 is, of course, directed to assisting in the application of s.51(1) of the Australian statute but, in my opinion, could serve also as a useful guide to the application of Hong Kong's s.16 to a case, like the present, where an

interest-bearing loan has been taken out for the purpose of paying a declared dividend.

31. For the reasons I have given this appeal should, in my opinion, be allowed. To the original question asked in the case stated I would answer "No". As to the further questions added by Deputy Judge Muttrie, I agree with Tang JA that the question relating to para.17 of the case stated does not need to be answered. As to the Board's conclusion that there was no evidential basis to support the assertion on behalf of Zeta that the new shareholders' loans were to provide Zeta with the additional working capital needed to pay the dividends that had been declared, I would hold that, on the evidence before the Board, and, in particular, the 1998/1999 accounts, the conclusion was one that no tribunal properly directing itself could have reached. I would order the respondent to pay Zeta's costs here and below.

Mr Justice Bokhary PJ :

32. The Court unanimously allows the appeal with costs here and below.

(Kemal Bokhary) Permanent Judge	(Patrick Chan) Permanent Judge	(R.A.V. Ribeiro) Permanent Judge

(Barry Mortimer) Non-Permanent Judge	(Lord Scott of Foscote) Non-Permanent Judge

Mr Denis Chang SC, Mr Ramesh Sujanani and Mr Newman Lam (instructed by Messrs Ford, Kwan & Co.) for the appellant

Mr Ambrose Ho SC and Mr Stewart KM Wong (instructed by the Department of Justice) for the respondent