HCIA 4/2016

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE
INLAND REVENUE APPEAL NO 4 OF 2016

IN THE MATTER OF an application for leave to appeal against the Decision of the Board of Review (Revenue) in B/R 28/13 dated 8 July 2016 (Case No. D15/16)

IN THE MATTER OF Section 69(3)(a)(ii) of the Inland Revenue Ordinance (Cap 112)

BETWEEN

THE COMMISSIONER OF INLAND REVENUE Applicant

and

RIGHT MARGIN LIMITED Respondent

Before: Hon G Lam J in Chambers
Date of Hearing: 26 September 2017
Date of Judgment: 12 October 2017

J U D G M E N T

Introduction

1. This is an application by the Commissioner of Inland Revenue under s 69 of the Inland Revenue Ordinance (Cap 112) for leave to appeal from the decision of the Board of Review dated 8 July 2016, whereby the Board allowed the appeal of the taxpayer against the profits tax assessments for 1999/00 and 2002/03 to 2006/07. The underlying dispute is whether the taxpayer should be allowed to deduct a sum of approximately HK$156.6 million from its assessable profits as a provision for bad debt in the assessment year 1999/00. If the deduction was upheld, as was the Board's conclusion, the taxpayer would have made a net loss for that year and, with the tax loss carried forward, would have no assessible profits for the years in dispute.

2. The facts of the case may be summarised as follows. The taxpayer is a wholly-owned subsidiary of Chime Corporation Limited, both of them being members of the Chinachem group of companies. The taxpayer's principal business activity was

money-lending, earning interest as income. In around 1993, five developers including Chinachem entered into a joint venture for a residential development in Kowloon. The corporate vehicle for the joint venture was Victory World Limited ("**VWL**"), incorporated in 1993, in which Chime became a 10% shareholder and the other four developers 50%, 20%, 10% and 10% shareholders respectively. The terms of the joint venture were subsequently formally drawn up in a joint venture agreement dated 7 May 1996 between the five shareholders and VWL ("**JVA**"). The terms of the JVA included the following:

> "6.1 It is the intention of the Shareholders that the Company shall, to the extent possible, raise funds from banks or similar sources to finance the Development Costs of the Property on the most favourable terms reasonably obtainable … If bank or external finance as aforesaid is not available or sufficient, then all or further Development Costs shall be financed by advances by way of Shareholders' loans by … Chime and … respectively in the Agreed Proportions within seven (7) days upon request by the Board of Directors. Such loans shall
>
> (a) be unsecured;
>
> (b) bear interest at a flat rate to be determined by the Board;
>
> (c) except as expressly provided in Clause 10.3, not subject to repayment as to principal or interest (if any) in whole or in part unless otherwise resolved by the Board except in the event of liquidation of the Company at which time all outstanding principal and accrued interest (if any) shall be and become immediately due and payable.
>
> …
>
> 10.3 In the event that the Completed Development or any part thereof is sold, the Shareholders shall procure that all sale proceeds received by the Company shall be applied:-
>
> Firstly: subject to Clause 10.1 and Clause 10.2, in discharge of all rent, taxes, rates and other outgoings whether governmental, municipal, contractual or otherwise, due and affecting the Property and/or the Company;
>
> Secondly: in discharge of all outstanding indebtedness (including principal, accrued interest and other monies) due to other banks or financial institutions;
>
> Thirdly: in settlement of all outstanding liabilities or outgoings due and payable to all other person(s)

firm(s) or company(ies) (other than the Shareholders);

Fourthly: in repayment of the advances from the Shareholders in proportion to the respective amounts of advances;

Fifthly: in payment of the accrued interests on the Shareholders' advances in proportion to the respective amounts of advances; and

Sixthly: in payment of dividends which shall be distributed to the Shareholders in accordance with Clause 10.2 as soon as reasonably practicable."

3. Shareholders' financing was duly provided by the developers to VWL, in the proportion of their shareholdings and, in the case of Chime, in the form of loans from the taxpayer (a subsidiary of Chime) to VWL. Interest was charged by the taxpayer which was reported as income on an accruals basis, as a result of which profits tax was paid on this interest income even though, as noted below, interest had not actually been received by the taxpayer. Up to June 1999, VWL had made certain repayments to the taxpayer which, as found by the Board, were all for repayment of principal only and not for interest.

4. As at June 1999, VWL owed the taxpayer approximately HK$399 million. By then, VWL had already sold the bulk of the units in the development at a very substantial loss. It had no other business apart from the development. The value of VWL's remaining assets was less than the amount outstanding to the taxpayer and the four other lenders of shareholder's loans. In these circumstances, the taxpayer claimed a provision for bad debt in respect of the anticipated inability to recover the outstanding principal and interest from VWL.

5. Based on a value of VWL's net assets as at 30 June 1999 (excluding shareholders' loans) in the sum of about HK$1.79 billion, the taxpayer accepted that it could expect to receive 10% thereof, ie HK$179 million, which would leave it with a shortfall of approximately HK$220 million. The taxpayer accordingly made a provision for doubtful debt in the amount of HK$220 million for the year ending 30 June 1999. On the Board's finding, approximately HK$156.6 million of this amount was in the nature of accrued outstanding interest.

6. In his determination, the Deputy Commissioner disallowed the claim for doubtful debt of HK$220 million in its entirety. The taxpayer appealed but at the hearing before the Board, the appeal was narrowed down to focus on the provision to the extent of the unpaid accrued interest of HK$156.6 million.

7. The governing statutory provision is s 16(1)(d) of the Inland Revenue Ordinance (Cap 112), which provides 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 —
>
> …
>
> (d) bad debts incurred in any trade, business or profession, proved to the satisfaction of the assessor to have become bad during the basis period for the year of assessment, and doubtful debts to the extent that they are respectively estimated to the satisfaction of the assessor to have become bad during the said basis period notwithstanding that such bad or doubtful debts were due and payable prior to the commencement of the said basis period:
>
> Provided that —
>
> (i) deductions under this paragraph shall be limited to debts which were included as a trading receipt in ascertaining the profits, in respect of which the person claiming the deduction is chargeable to tax under this Part, of the period within which they arose, and debts in respect of money lent, in the ordinary course of the business of the lending of money within Hong Kong, by a person who carries on that business;
>
> (ii) all sums recovered during the said basis period on account of amounts previously allowed in respect of bad or doubtful debts shall for the purposes of this Ordinance be treated as part of the profits of the trade, business or profession for that basis period;"

8. It is common ground that the test of whether a debt is bad or irrecoverable is whether a reasonable and prudent businessperson would have concluded that, on the balance of probabilities, the debt was unlikely to be recovered: *Graham v Commissioner of Inland Revenue* (1995) 17 NZTC 12,107 at 12,110.

9. S 69 of the Ordinance provides for appeal from the Board's decision to the Court of First Instance "on a ground involving only a question of law". It does not

provide for an appeal by way of rehearing. S 69(3)(e) provides that leave to appeal "must not be granted" unless the court is satisfied:

> "(i) that a question of law is involved in the proposed appeal; and
>
> (ii) that —
>
> (A) the proposed appeal has a reasonable prospect of success; or
>
> (B) there is some other reason in the interests of justice why the proposed appeal should be heard."

It is therefore crucial to focus on the question of law involved in any proposed ground of appeal. Further, Practice Direction 34 paragraph 2(2) requires the Applicant in his statement to "identify and state precisely the question of law involved in each ground".

10. It is well-established that attacks on findings of fact only raise questions of law in very limited circumstances, such as where it is said there is no evidence at all to support the finding. The extent to which a particular piece of evidence should be accepted or rejected, and the weight to be given to it, are matters for the Board and not the court: *Aust-Key Co Ltd v Commissioner of Inland Revenue* [2001] 2 HKLRD 275, 281H; *Runa Begum v Tower Hamlets London Borough Council* [2003] 2 AC 430, §99. In this context, the cautionary notes sounded by Evans LJ in *Georgiou v Customs and Excise Commissioners* [1996] STC 463, 476 are well worth bearing in mind:

> "It is right, in my judgment, to strike two cautionary notes at this stage. There is a well-recognised need for caution in permitting challenges to findings of fact on the ground that they raise this kind of question of law. That is well seen in arbitration cases and in many others. It is all too easy for a so-called question of law to become no more than a disguised attack on findings of fact which must be accepted by the courts. As this case demonstrates, it is all too easy for the appeals procedure to the High Court to be misused in this way. Secondly, the nature of the factual inquiry which an appellate court can and does undertake in a proper case is essentially different from the decision-making process which is undertaken by the tribunal of fact. The question is not, has the party upon whom rests the burden of proof established on the balance of probabilities the facts upon which he relies, but, was there evidence before the tribunal which was sufficient to support the finding which it made? In other words, was the finding one which the tribunal was entitled to make? Clearly, if there was no evidence, or the evidence was to the contrary effect, the tribunal was not so entitled."

11. In the present case, the Applicant's statement listed no fewer than

12 grounds of appeal, each said to involve a question of law. Mr Brewer, who appeared on behalf of the Commissioner at this hearing but did not appear before the Board or sign the grounds, indicated that the primary grounds are Grounds 1 to 4, especially Ground 4, but the other grounds were not expressly abandoned which therefore remain to be dealt with albeit briefly.

12. Under Ground 1, the Applicant asserts that it is questionable whether sufficient evidence had been presented to the Board by the taxpayer to satisfy an assessor that the provision for HK$156.6 million was a doubtful debt estimated to his satisfaction to have become bad. The question of law said to be involved in this ground is specified to be: was the Board wrong in law in coming to the conclusion that the taxpayer had discharged its burden of proof for demonstrating to the Board that the provision for the interest of HK$156,615,001 was a doubtful debt estimated to the satisfaction of the assessor to have become bad during the basis period?

13. I have to say this is not a proper ground of appeal or question of law. It merely turns the conclusion of the Board into the form of a question adding a question mark at the end. In *Commissioner of Inland Revenue v Inland Revenue Board of Review* [1989] 2 HKLR 40 at 50G and 58B (commonly known as the "*Aspiration case*"), Barnett J stated that imprecise, vague or ambiguous questions are not acceptable. While that was said in the context of the former procedure of appeal by way of case stated, I see no reason why the standard required of the questions of law advanced under the new s 69 should be any lower.

14. Ground 2 relies on a further loan of HK$200,000 lent by the taxpayer to VWL in February 2002 as being "wholly inconsistent" with the making of provision for doubtful debt in 1999. It is asserted that the Board had failed to attach proper weight to this fact or had altogether disregarded it in evaluating the evidence. The question of law said to be involved is this: was the Board wrong in law in putting no or no sufficient weight on the fact that a further loan was lent by the taxpayer to VWL on 1 February 2002 after the making of provision for the allegedly doubtful debt in 1999?

15. Insofar as it is suggested that the Board had ignored the further loan, this ground is misconceived. Paragraph 24 of the Board's decision explained why they did not find the further loan decisive and referred also broadly to the taxpayer's evidence, which was effectively unchallenged, of how the further loan came to be lent, which was not inconsistent with the view taken earlier that part of the money outstanding would probably not be recovered.

16. Insofar as this ground asserts that the Board did not put sufficient weight on the further loan, it does not raise a question of law. The question of how much weight to put on a piece of evidence is a matter for the Board as the fact-finding tribunal.

17. Ground 3 asserts that the Board disregarded or put no or no sufficient weight on the strict legal/contractual right and obligations between VWL and the taxpayer. The Applicant has seized upon this sentence in paragraph 24 of the Board's decision:

> "This Board must bear in mind that the forensic exercise is not so much the determination of the strict legal/contractual right and obligations between VWL and the taxpayer".

The question of law said to be involved is: was it reasonable for the Board to conclude that the debts or the relevant part of them was/were irrecoverable if the Board had correctly directed itself to the legal/contractual right and obligations between the taxpayer and VWL and the evidence before it?

18. It seems to me that this ground as formulated in the Applicant's statement takes the Board's expressions out of their context. Immediately following the words quoted above from paragraph 24, the Board continued: "but rather the ultimate fact as to the likelihood of recovery of the debt or the relevant part of it". The Board then stated that it had to bear in mind the relationship between the taxpayer, Chime and VWL, the terms of the JVA notwithstanding that the taxpayer was not a party to it, and the factual matrix of how the loan came to be lent.

19. Moreover, it is difficult to see how this ground advances the Applicant's case. The Board did not decide that the provision was properly made on the ground that the loan was irrecoverable in law. On the contrary, the Board seems to me to have proceeded on the basis that the loan was legally enforceable but that on the facts and the commercial realities, there was little that the taxpayer could do by way of legal enforcement: see paragraph 5 of the Board's decision.

20. In his skeleton, Mr Brewer appears to have shifted the attack under this ground to the Board's finding that previous repayments from VWL were for principal, not interest, despite the fact that the taxpayer was not party to the JVA. This ground of attack as reformulated seems to me to have no prospect because, as Ms Cheng SC submitted on behalf of the taxpayer, the unchallenged evidence before the Board was that the taxpayer and VWL had agreed that the advances made by the taxpayer would be governed by the relevant terms of the JVA – which was hardly surprising given that the taxpayer had lent the money in order to fulfil the obligation of its parent company, Chime, to provide shareholders' loans under the JVA and that in fact VWL and all the other shareholder lenders had treated the repayments in the same way.

21. Ground 4, which Mr Brewer put forward as his primary ground, relies on the fact that the taxpayer had never sued VWL or taken any enforcement step to recover the loan, and the fact that the notes to the accounts of VWL for the year ending 30 June 1999 stated that they had been prepared on a going concern basis because the shareholders had agreed to provide adequate funds for VWL to meet its liabilities as they fell due. The Applicant criticizes the following passage in paragraph 25 of the Board's decision:

> "The contrary argument is: if VWL did not have sufficient asset, it being of limited liability as a corporation, how much could suing VWL

> or winding up VWL help to eventually recover the debt to the extent of the last $156 million of the total debt of $399 million owed to the taxpayer?"

It is said that this question did not provide any satisfactory answer as to how one could come to a *bona fide* conclusion that the debts were irrecoverable. It is further said that the taxpayer had not explained why the statement in the notes to VWL's accounts should be regarded as an empty promise. The question of law said to be involved is: was the Board wrong in law in brushing aside or putting little weight to such fact and evidence such that it could not have reasonably reached the conclusion that the debts or the relevant part of them was/were unrecoverable?

22. This again seems to me to be not really a question of law but a thinly disguised attack on the factual conclusions of the Board. The real criticism is that the Board had not put as much weight as the Applicant would like on the fact that the taxpayer never sued VWL and on the statement in the notes to the accounts. The Applicant has, rightly in my view, not advanced a general proposition of law that before a provision can be recognised, the taxpayer must have taken active legal steps to recover the loan and failed. It is a question that depends on the facts of the case. There may be cases in which a reasonable and prudent businessman can readily conclude, without incurring expenses to sue the debtor, that the debt is unlikely to be recovered. The law does not require him to throw good money after bad.

23. Mr Brewer said the taxpayer, as a creditor, could at least have issued a statutory demand or attempted to persuade other creditors to subordinate their debts to its loans or to persuade VWL to restructure its financing. In my view, with respect, the Applicant's position is wholly unrealistic in the light of the special facts and circumstances of this case. This was not an arm's length situation. The creditor (taxpayer) was the wholly-owned subsidiary of Chime, which was a shareholder (10%) in the debtor (VWL). Four other developer groups had a similar relationship with VWL *pro rata*. The evidence was, as the Applicant accepted before the Board, that the taxpayer simply did as it was expected to do by Chime. To my mind, it is fanciful to suggest that the other developers, who controlled VWL, would have agreed that VWL should repay the taxpayer first, in priority to everyone else, on sight of a statutory demand, or would have agreed to subordinate their shareholders' loans to those lent by the taxpayer. The Board was fully entitled to accept the realities as explained by Mr K P Chan (a director of the taxpayer who gave evidence) as being consonant with commercial sense.

24. Ground 5 is related to Ground 4 and focuses on the Board's view relating to the notes to the audited accounts. In paragraph 27 of its decision, the Board stated:

> "One sometimes sees that sort of message of comfort from the shareholders of a loss-making company to its auditor pursuant to a request from the latter during an annual audit of the accounts, before the auditor would be willing to prepare the accounts on a going concern

> basis … Even if one is to push the argument and ask whether the taxpayer can wind up VWL so that its liquidator will enforce that 'agreement' …, this Board finds that there was no undertaking given to VWL (as opposed to the auditor), and finds that any such undertaking, if given, is not enforceable as too uncertain or for lack of good consideration. Furthermore, the relevant ultimate issue is rather an objective assessment of recoverability of the debt by a prudent and reasonable person. The prudent view should be that there is the substantial risk that it might not be an undertaking to VWL at all, and the blank cheque is probably not legally binding on the shareholders for uncertainty or lack of good consideration."

The Applicant argues that there was no evidence for the Board to reach the view that the undertaking was nothing more than a message of comfort which was unenforceable and not legally binding. The question of law said to be involved in this ground is: was the Board wrong in law in finding that, on the available evidence, there was no undertaking given by the shareholders to VWL, and that any such undertaking, if given, was not enforceable and not legally binding on the shareholders?

25. In fact, the audited accounts only stated that the shareholders had agreed to provide funds for VWL to meet its liabilities as they fell due. There was nothing to suggest that there was an undertaking given by the shareholders to VWL that was enforceable or binding. Moreover, on the terms of the note to the accounts, funds would only be provided to meet liabilities as they fell due. According to the terms of the JVA, the loan from the taxpayer which was regarded as a shareholder's loan from the Chinachem Group would not fall due unless and until VWL's board so resolved. In these circumstances, I do not think it can be said that there was no evidence at all for the Board to come to the conclusion as it did.

26. The question of law arising from Ground 6 is said to be this: was the Board wrong in law to give undue weight on the value on the unsold units held by VWL in concluding that the provision was a doubtful debt estimated to the satisfaction of the assessor to have become bad?

27. This ground has in my view no merit. The value of the unsold units still held by VWL as at June 1999 was clearly relevant to the ability of VWL to repay its liabilities. The question of how much weight to put on this piece of fact is a matter for the Board and not a question of law.

28. Ground 7 raises the question whether the Board was wrong in law in the absence of any or any sufficient evidence to accept the taxpayer's claim that the likely post-June 1999 repayments should be expected to be insufficient, leaving a bad debt of at least HK$156 million.

29. The fact is that VWL was a single-project company whose only substantial assets were the unsold units in the development. The Board accepted the

taxpayer's estimate that 10% of VWL's net assets (excluding its liabilities on the shareholders' loans) amounting to about HK$179 million could be expected to be ultimately repaid to the taxpayer, leaving a shortfall of HK$220 million (HK$399 million – HK$179 million). There was therefore ample evidence capable of supporting the Board's conclusion. This ground therefore has no prospect of success.

30. Ground 8 attacks paragraph 36 of the Board's decision in which the Board said that Chime was a party to the JVA and was in control of the taxpayer and could be required by the other parties to the JVA to perform its obligations thereunder by procuring the taxpayer to do so. The Board also stated there that the taxpayer and VWL in fact conducted themselves on that understanding and the interest charged was so calculated. The question of law said to arise is: was the Board wrong in law in failing to properly consider, or give any or any sufficient weight on, the strict legal/contractual right and obligations between VWL and the taxpayer on the one hand, and in making the contrary finding that the taxpayer and VWL conducted themselves according to some understanding on the other hand?

31. I have already dealt with the first part of this question in the context of Ground 3 above. It seems to be suggested that the Board's finding about the understanding between the taxpayer and VWL was inconsistent with the Board's views as expressed in paragraph 24 of its decision. I do not think there is any inconsistency. In paragraph 24, the Board was emphasizing that what they were concerned with was the facts and realities relevant to the likelihood of recovery of the debt rather than the determination of the strict legal/contractual right and obligations between VWL and the taxpayer. In paragraph 36, the Board referred to one aspect of the facts and reality, which was supported by unchallenged evidence, to the effect that the understanding between the taxpayer and VWL was that the advances made by the taxpayer would follow the terms of the JVA. There is no inconsistency giving rise to any question of law.

32. Grounds 9 and 10 criticize the Board's decision on the basis that the outstanding indebtedness in fact had arisen from various advances made by the taxpayer to VWL and that the Board should not have allowed deduction for a single, segregable and specific provision of HK$156.6 million. The questions of law said to arise are (a) was the Board wrong in law in allowing deduction for a single provision made for numerous bad debts and (b) assuming it was permissible in some circumstances, was the Board wrong in law in finding that the taxpayer made one segregable and specific provision of HK$156.6 million in respect of interest in the absence of sufficient evidence?

33. Question (a) seems to me not to be a proper question because it fails to identify precisely the point of law involved. Question (b) seems to be misconceived, for the fact was that the taxpayer made a provision of HK$220 million of which HK$156.6 million represented interest accrued but not yet received. In any event, for the reasons set out in the Respondent's statement at paragraphs 35 to 43, these proposed grounds do not warrant leave to be given for an appeal.

34. Ground 11 asserts that the two parts in proviso (i) to s 16(1)(d) of the

Ordinance should be read conjunctively and cumulatively so that to be deductible, the taxpayer must show that the debts were both included as trading receipts and lent in the ordinary course of the business of the lending of money.

35. On the wording of the proviso, this ground must in my view be rejected. The plain and ordinary meaning of the words in the proviso is that the debts under both the first part and the second part of proviso (i) are deductible. There is nothing to indicate that debts which were included as trading receipts in ascertaining the profits must also, in the case of a money lender, have been lent in the ordinary course of the business of the lending of money. There is no reason in justice to deny a money lender the right to make a deduction where, as in this case, interest income not actually received had been taxed on an accrual basis when it can be shown that such interest was unlikely actually to be received, merely because the loan was not lent in the ordinary course of the business of the lending of money.

36. Ground 12, like Ground 1, is no more than a general assertion, questioning the ultimate conclusion of the Board without identifying any specific legal error or question. It adds nothing and raises no proper question of law.

37. For the above reasons, the application for leave to appeal is dismissed. There will be an order *nisi* that the Applicant is to pay the costs of the taxpayer, to be taxed if not agreed.

(Godfrey Lam)
Judge of the Court of First Instance
High Court

Mr John Brewer, instructed by Department of Justice, for the Applicant

Ms Yvonne Cheng SC, instructed by Baker & McKenzie, for the Respondent