Case No. D14/14

Profits tax – appellant obtaining loan to finance working capital and property upgrades – interest expense arising from loan – whether loan interest deductible – sections 16(1)(a), 17(1)(b), 25, 61 and 61A of the Inland Revenue Ordinance (Chapter 112) ('IRO').

Practice and procedure – language of proceedings – appellant preferring 'Cantonese' as language of proceedings – whether the Board bound to adopt 'Cantonese' as language of proceedings – sections 2, 3(1) and 5 of the Official Languages Ordinance (Chapter 5) ('OLO').

Panel: Albert T da Rosa, Jr. (chairman), Elaine Liu Yuk Ling and Mak Po Lung.

Date of hearing: 21 February 2014.
Date of decision: 26 August 2014.

Mr D and Ms E were spouses. They were also the only shareholders and directors of the Appellant and Company B. In its profits and loss accounts between 1998/99 and 2002/2003, the Appellant charged loan interest expenses in respect of $25 million due to Company B (which was increased to $30 million in 2000).

In 2007, the Commissioner upheld, *inter alia*, that the Appellant should not be allowed any deduction of interest expenses payable to Company B in respect of the amount due to it for 1998/99 to 2002/03. The Appellant did not appeal against this determination.

The Appellant later filed its profits tax returns for 2004/05 and 2006/07 by deducting loan interest. The Appellant claimed that: (a) up till 2002, the Appellant financed the property upgrades and working capital by advances from director or Company B; (b) the Appellant owed Company B $30 million as at March 2003. In 2003/04, Company B demanded repayment of the loan and the Appellant was forced to obtain a bank loan of $30 million from Bank C to repay Company B. The said loan substituted the amount from Company B which was used to finance the Appellant's working capital and property upgrades; (c) as at March 2006, the loan had been reduced to $26 million. Of the loan, $3 million was used to finance 2005/06 profits tax payment and the balance to finance its working capital and property upgrades. The balance was carried forward to March 2007 and the additional loan for 2006/07 was raised from Bank C in return, lending to Company B for investment purposes; (e) the interest on the loan was deductible as the main purpose of the loan was to provide continual finance of its working capital and property upgrades. A balance sheet analysis was adduced in support of the claim.

The Commissioner raised on the Appellant Additional Profits Tax Assessment for 2004/05 and Revised Profits Tax Assessment for 2006/07. The Appellant objected to the above, claiming that it should be allowed deduction of bank loan interest for 2004/05 and that the assessment for 2006/07 was estimated.

The Commissioner upheld the assessment. The Appellant appealed to the Board, contending that: (a) the Appellant was not chargeable for additional tax in connection with the disallowed interest for 2004/05 and 2006/07 as the Appellant considered the interest should be deductible; (b) the additional tax for 2004/05 and the revised tax payable for 2006/07 were excessive having regard to the circumstances of the case.

At the hearing, both parties did not call any witness. Without consulting the Commissioner, the Appellant also informed the Board that 'the preferred language of the proceedings is Cantonese'.

Held:

Language of Proceedings

1. The right to employ or utilize one's preferred language was not the same as a preference that others should adopt that language as the language of the proceedings. Under OLO, Cantonese was not an official language. Wide discretion conferred by OLO to choose to use 'either or both' of the official languages in proceedings or any part thereof was not applicable to proceedings before the Board. There was also nothing to explain (apart from mere assertion from solicitors) why Cantonese was preferred in the proceedings. (Re Ching Kai-nam Gary [2002-04] 10 HKPLR 89 and HKSAR v Kong Lai Wah [2009] 1 HKC 459 considered).

Substantive Appeal

2. In the absence of any finding that the dividend declaration and loan as a single transaction in the sense that but for the dividend declaration the loans would not have been needed where correlated the loan to the perseverant of the need for fresh working capital, one did not merely look at the balance sheet of a taxpayer, but had to ask why the loan was incurred and consider the evidence, and not just the arguments proffered in explanation (Zeta Estates Ltd v CIR (2007) 10 HKCFAR 196 considered).

3. There was no evidence that the deduction for interest payments were indeed expenses made by the Appellant to Bank C in respect of the loan. However, unless one had sight of a cash flow statement or projection on a day-to-day basis, one would not know whether there was any actual cash need as at the day of any particular transaction. The situation was more dubious especially

in view of the failure to produce evidence correlating the loans with the cash flow obligations. Hence, the Board was not satisfied that the Appellant's loan from Company B was for the purpose of discharging its debts; that the Appellant had insufficient liquidity to repay the loan from Company B and Bank C; and that the purpose of the Appellant's loan from Bank C was 'to maintain an existing profit producing capacity'.

4. Further or alternatively, sections 61 and 61A of IRO applied to disregard the purported loan. Also, section 61A of IRO also applied to loan by Bank C, such that the sole or dominant purpose for the said loan was for tax benefit of claiming interest deduction under profits tax. Sections 61 and 61A were engaged where there was a resultant tax benefit to 'any person', which was Company B. Even applying the general principles, it was artificial. (Ngai Lik Electronics Co Ltd v CIR [2009] 5 HKLRD 334, Shui On Credit Co Ltd v CIR (2009) 12 HKCFAR 392, Commissioner of Inland Revenue v HIT Finance Ltd (2007) 10 HKCFAR 717 and IRC v Challenge Corporation Ltd [1987] AC 155 considered).

Appeal dismissed.

Cases referred to:

Re Cheng Kai-nam Gary [2002-04] 10 HKPLR 89
HKSAR v Kong Lai Wah [2009] 1 HKC 459
Zeta Estates Ltd v CIR (2007) 10 HKCFAR 196
D34/04, IRBRD, vol 19, 294
Zeta Estates Ltd v CIR [2006] HKCA 79
Ngai Lik Electronics Co Ltd v CIR [2009] 5 HKLRD 334
Shui On Credit Co Ltd v CIR (2009) 12 HKCFAR 392
Commissioner of Inland Revenue v HIT Finance Ltd (2007) 10 HKCFAR 717
IRC v Challenge Corporation Ltd [1987] AC 155

Danny Fung, Counsel, Wong Kam Wah, Conti of Messrs Edward Lau, Wong & Lou, Solicitors and Lo Chin Man of Billy Ho and Company, for the Appellant.
Jonathan Chang, Counsel, Agnes C M Chan, Senior Government Counsel and Fung Ka Leung, Senior Assessor, for the Commissioner of Inland Revenue.

Decision:

Introduction

1. By a determination ('the Determination') dated 12 August 2013 the Deputy Commissioner of Inland Revenue ('the CIR')

1.1. upheld the Additional Profits Tax assessment on the Appellant for the year of Assessment 2004/05 of HK$489,889 with additional tax payable thereon of HK85,730; and

1.2. revised the Profits Tax assessment on the Appellant for the year of Assessment 2006/07 to HK$16,067,427 with revised tax payable thereon in the sum of HK2,811,799.

2. The Appellant appeals to this Board on the Determination. The grounds given are:

2.1. '[the Appellant] is not chargeable for additional tax in connection with the disallowed interest for the said years of assessment [i.e. 2004/05 and 2006/07] as the Appellant considers the interest should be deductible …'; and

2.2. 'The additional taxes for 2004/05 and the revised tax payable for 2006/07 are excessive having regard to the circumstances of [the Appellant's] case.'

3. The Respondent contends that section 61A of the Inland Revenue Ordinance Chapter 112 ('the Ordinance') applies in relation to the assessment under appeal and by letter dated 24 January 2014 gave the following particulars:

3.1.	Relevant Person:	Company A
3.2.	Transaction:	The alleged borrowing of HK$30,000,000 from Company B. The entering into of the alleged loan agreement of HK$30,000,000 with Bank C and the purported repayment of HK$30,000,000 to Company B. The purported increases of loan borrow from Bank C (excluding loan borrowed for tax payment, if applicable) in the years of assessment 2005/06 and 2006/07.

3.3.	Tax Benefit:	Reduction in Company A's liabilities to pay profits tax by amounts which are calculated by multiplying the relevant profits tax rate by that of interest expenses which are not allowed to be deducted.
3.4.	Persons having the relevant dominant purposes:	Company A, Company B, Mr D and/or Ms E

4. The alleged borrowing of HK$30,000,000 by the Appellant from Company B is called 'the Company B Loan'.

Procedural matters

The choice of language

5. By letter dated 24 October 2013 to the Clerk to the Board, the Appellant's solicitors informed the Board that the 'preferred language of the proceedings is Cantonese'. At that time, the Appellant was legally represented and did not intend to call any witness.

6. We wish to repeat what Hartmann J (as he then was) said in Re Cheng Kai-nam Gary [2002-04] 10 HKPLR 89 that

> ' *19. … In my judgment, the constitutional right of a person to use the Chinese language in a court of law in Hong Kong means no more than the right of that person to employ that language, that is, to utilize it, for the purpose of forwarding or protecting his interests. That right to employ or utilize the language does not imply a reciprocal obligation on the part of the court to speak and read that language. It is sufficient if processes, such as the employment of interpreters or translators, exist to facilitate the court comprehending what is said or written.*'

7. Thus, the right to employ or utilize one's preferred language (through interpreter where necessary) is not the same as a preference that others should adopt that language as the language of the proceedings in question which, *inter alia*, also affects the language for keeping the records of the proceedings.

8. Section 3(1) of Official Languages Ordinance, Chapter 5 provides

> ' *The English and* ***Chinese languages*** *are declared to be the official languages of Hong Kong for the purposes of communication between the Government or any public officer and members of the public and for court proceedings*'.
>
> The Chinese version of the section reads

> '*現予宣布：在政府或公職人員與公眾人士之間的事務往來上以及在法院程序上，中文和英文是香港的法定語文。*'

'Cantonese'（'廣東話' or '粵語'）as such, which is a dialect of the Chinese language, is not stated in the section as one of the two official languages – 'Chinese'（'中文'） is.

9. The language of the proceedings before the Board (which is deemed a 'court' under section 2 of the Official Languages Ordinance) covers both the oral and written elements of the proceedings [See HKSAR v Kong Lai Wah [2009] 1 HKC 459 CACC91/2008 (11 November 2008)]. For such purpose:

9.1. the oral element of Chinese in Hong Kong includes Cantonese or Punti; and

9.2. the written element in official communications in the Chinese language is the 'written vernacular Chinese' (Chinese: 白話; in pinyin: báihuà also commonly called 'standard written Chinese' or 'modern written Chinese') and refers to forms of written Chinese based on the vernacular Mandarin, in contrast to Classical Chinese. This is not the written from of the Cantonese colloquial style.

10. Section 5 of the Official Languages Ordinance reads

> '*A judge, magistrate or other judicial officer may use either or both of the official languages in any proceedings or a part of any proceedings before him as he thinks fit.*'

A member of the board is not a judge or magistrate and is also not a 'judicial officer' which refers to someone who occupies an office set out in Schedule 1 of the Judicial Officers Recommendation Commission Ordinance Chapter 92. Thus, wide discretion conferred by section 5 of the Official Languages Ordinance to choose to use 'either or both' of the official languages in proceedings **or any part** thereof is not applicable to proceedings before the Board.

11. In any event, the Determination, Submissions, and Notice of Appeal in this case are all in English. Apart from a mere assertion by the Appellant's solicitors that 'The preferred language of the proceedings is Cantonese', there is nothing to explain the basis of the preference, the impact of such decision on translation of the known English documents, or the impact on the task of co-relating the English and the Chinese/Cantonese terms at the hearing and in the decision making process. The Respondent had not been consulted by the Appellant on the question of language preference.

12. The Appellant's application for adopting Cantonese as the language for the proceedings was therefore refused by the chairman at that time.

2007 Determination

13. In a previous determination ('the 2007 Determination') dated 30 April 2007, by the then Deputy Commissioner of Inland Revenue upheld the relevant additional tax assessments on Company A ('the Appellant') for the years of assessment

13.1. 1997/98 of HK$1,083,624 with additional tax payable thereon of HK$160,918;

13.2. 1998/99 of HK$4,188,618 with additional tax payable thereon of HK$670,179;

13.3. 1999/2000 of HK$4,661,504 with additional tax payable thereon of HK$745,840;

13.4. 2000/01 of HK$3,902,415 with additional tax payable thereon of HK$624,386;

13.5. 2001/02 of HK$3,794,058 with additional tax payable thereon of HK$607,050;

13.6. 2002/03 of HK$3,790,379 with additional tax payable thereon of HK$606,460.

14. The Appellant did not appeal against the 2007 Determination nor was there agreement to the underlying facts found by the Commissioner for the purposes of the 2007 Determination. The concepts relating to *res judicata* are not engaged in determinations by the Commissioner. At the highest, as contended by the Respondent, the Company B Loan was disregarded in the Previous Determination and unless the Appellant can adduce additional evidence at the present hearing, the Company B loan should likewise be disregarded. The 2007 Determination is only relevant to the extent the Respondent seeks to invoke 'parity of reasoning'.

Other Accounts

15. At the hearing, the Appellant confirmed that it is not relying on the bundle of documents in 'Taxpayer Bundle 2' – 'Bundle of Financial Statements' beyond the relevant years of assessment under appeal but that they were only included in the bundle in case the Respondent may wish to make submissions on them so that the Appellant will have sufficient basis to answer. At the end of the day, apart from the documents under tab 14 (Statement of Accounts of the Appellant for the year ended 31st March 1998), tab 21 (Financial Statement of the Appellant for the year ended 31 March 2005), the documents in 'Taxpayer Bundle 2' remain untouched.

No Witness

16. No factual witness was called by either party. By agreement of the parties, the purported witness statement of Ms F was removed from the bundle while new documents otherwise referred to in her purported statement remains.

Agreed facts

17. At the hearing the parties agreed to treat paragraphs 1 to 16 of section 1 of the Determination as agreed facts. They are repeated verbatim below:

> ' (1) [Company A] ('the Company') has objected to the additional Profits Tax assessment for the year of assessment 2004/05 and the Profits Tax assessment for the year of assessment 2006/07 raised on it. The Company claims that it should be allowed deduction of bank loan interest for the year of assessment 2004/05 and that the assessment for the year of assessment 2006/07 was estimated.
>
> (2) The Company and [Company B] were private companies incorporated in Hong Kong in 1970 and 1981 respectively. At the material times, [Mr D] and his wife, [Ms E], were sole-shareholders and directors of the Company and [Company B].
>
> (3) The Company carried on the business of property investment. It closed its annual accounts on 31 March.
>
> (4) (a) In its profits and loss accounts for the years ended 31 March 1999 to 2003, the Company charged the following loan interest expenses in respect of an amount due to [Company B] of $25 million, which was increased to $30 million in September 2000.
>
> | | 1998/99 | 1999/00 | 2000/01 | 2001/02 | 2002/03 |
> |---|---|---|---|---|---|
> | Loan interest expenses payable to [Company B] | $2,709,075 | $2,389,374 | $2,588,255 | $2,400,000 | $2,400,000 |
>
> (b) By a determination dated 30 April 2007 ('the 2007 Determination), the Deputy Commissioner upheld, among other things, that the Company should not be allowed any deduction of the interest expenses payable by it to [Company B] in respect of the amount due to [Company B] for the years of assessment 1998/99 to 2002/03 for the following reasons:
>
> (i) The Company had not provided any satisfactory evidence to establish that it was contractually liable to pay interest to [Company B]. In particular, no loan agreement or other

evidence were produced showing the advances of the alleged loan from [Company B].

(ii) Section 61 of the Inland Revenue Ordinance ('the Ordinance') was applicable to the alleged borrowing by the Company from [Company B] which involved no actual fund movement but mere accounting entries and circular movement of paper fund which started from [Company B] to the Company, then from the Company to their common shareholders/directors and back to [Company B].

(iii) The alleged borrowing by the Company from [Company B] was a transaction entered into for the sole or dominant purpose of enabling the Company to obtain a tax benefit within the terms of section 61A of the Ordinance.

A copy of the 2007 Determination is at Appendix A. [The 2007 Determination is not reproduced herein.]

(c) The Company did not appeal against the 2007 Determination.

(5) The Company filed its Profits Tax return for the year of assessment 2004/05 with supporting financial statements for the year ended 31 March 2005 and tax computations. The Company declared assessable profits of $13,269,115 in the tax return which was arrived at after deducting, among other things, loan interest of $368,749 and professional fees of $121,140.

(6) The Assessor raised on the Company the following 2004/05 Profits Tax Assessment based on the assessable profits declared in the tax returns:

Assessable Profits	$13,269,115
Tax Payable thereon	$2,322,095

The Company did not object to the assessment.

(7) The Company failed to file 2006/07 Profits Tax return within stipulated time. The Assessor raised on the Company the following estimated 2006/07 Profits Tax assessment:

Estimated Assessable Profits	$13,780,000
Tax Payable thereon	$2,411,500

(8) The Company through Messrs Billy Ho and Company ('the Representatives') objected to the 2006/07 Profits Tax assessment on the

ground that it was estimated.

(9) To validate its objection, the Company filed its Profits Tax return for the year of assessment 2006/07 with supporting financial statements for the year ended 31 March 2007 and tax computations. The Company in the tax return declared assessable profits of $15,060,693 which was arrived at after deducting loan interest of $1,140,406. The Company further claimed set-off of Property Tax of $311,345 against its Profits Tax liabilities under section 25 of the Ordinance.

(10) The Assessor ascertained that Property Tax of $311,345 was charged and paid in respect of properties solely owned by [Mr D].

(11) In reply to the Assessor's enquiries regarding interest expenses of $1,140,406 [Fact (9)], the Representatives provided the following details:

(a) Up till 2002, the Company financed the property upgrade and working capital by advances from the director or Company B.

(b) The Company owed Company B in the amount of $30 million as at 31 March 2003. Company B demanded repayment of the loan in the year of assessment 2003/04. The Company was forced to obtain a bank loan of $30 million from Bank C ('the Bank C Loan') to repay Company B. The loan from Bank C substituted the amount from Company B which was used to finance the Company's working capital and property upgrade.

(c) "As at 31 March 2006, the loan amount had been reduced to $26 million. Of the loan amount, $3 million was used to finance 05/06 profits tax payment and the balance of the source to finance its working capital and property upgrades. The balance was carried forward to 31 March 2007 and the additional loan for the year 2006/07 was raised from Bank C in return, lending to (Company B) for investment purposes."

(d) The breakdown of the sum of $1,140,406 was as follows:

	$
Interest on the Bank C Loan	1,006,733.76
Others	133,672.10
	1,140,405.86

(e) The interest on the Bank C Loan was deductible as the main purpose of the loan was to provide "continual finance of its

working capital and property upgrades".

(f) A balance sheet analysis appended as Appendix B was adduced in support of the claim.

(12) The Assessor reviewed the Company's deduction claims of interest expenses and professional fees for the year of assessment 2004/05. The Assessor asked the Company to supply information and documents to support the deduction of the two items.

(13) Upon the Company's failure to give a reply, the Assessor raised on the Company the following 2004/05 Additional Profits Tax Assessment:

	$
Disallowing deduction of	
Loan interest	368,749
Professional fees	121,140
Additional Assessable Profits	489,889
Additional Tax Payable thereon	85,730

(14) The Company through the Representatives objected to the 2004/05 Additional Profits Tax Assessment in the following terms:

> "(The Company) does not agree that the bank interest is disallowed … (The Company) only agree to add back the professional fee of $121,140."

(15) The Assessor asked the Company to supply, among other things, the following information:

Interest of $368,749 for the year of assessment 2004/05

(a) whether the interest expenses were in respect of loan obtained to substitute the loan from Company B;

(b) if otherwise, the nature of the loan and the recipient of the interest;

Interest of $1,044,470 on the Bank C Loan for the year of assessment 2006/07

(a) copy of loan agreement;

(b) copy of bank statement showing drawdown of the Bank C Loan and repayment made to Company B.

The Assessor has received no reply from the Company up till the present.

(16) The Assessor now considers that the 2006/07 Profits Tax Assessment should be revised as follows:

	$
Profits per return [Fact (9)]	15,060,693
Add: Interest on the Bank C Loan [Fact (11)(d)]	1,006,734
Revised Assessable Profits	16,067,427
Revised Tax Payable thereon	2,811,799'

18. Most of the agreed facts relate to what transpired in the correspondence between the parties rather than the substance of what is being contended for by either party in such correspondence.

19. Our attention has also been drawn to the documents in the Appellant's bundles of documents (namely: 'Taxpayer Bundle 1' and 'Taxpayer Bundle 2') and the Respondent's Bundle the authenticity of which are not in dispute. However, as mentioned in paragraph 15 herein, nothing of significance turned on Taxpayer Bundle 2 'Bundle of Financial Statements' beyond the relevant years of assessment under appeal.

The crux of the appeal

20. The crux of the appeal is

20.1. as regards the 2004/05 Additional Tax, whether the amounts of HK$368,749 being the '2004/05 Loan interest' (the Appellant having abandoned the challenge to disallowance of '2004/05 Professional Fees' of HK$121,140) is deductible from the additional tax assessment as contended by the Appellant and if not the additional tax assessment ought to have been HK$489,889 as contended by the Respondent;

20.2. as regards the 2006/07 Profits Tax Assessment, whether the loan interest of HK$1,006,734 ('the 2004/05 Bank C Loan Interest') is deductible as contended by the Appellant and if not it should have been HK$16,067,427 as contended by the Respondent.

The Ordinance

21. Section 16(1)(a) of the Ordinance provides:

' *(1) In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all*

> *outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period, including –*
>
> *(a) where the conditions for the application of this paragraph is satisfied under subsection (2), and subject to subsections (2A), (2B) and (2C), sums payable by such person by way of interest on any money borrowed by him for the purpose of producing such profits …*' (Emphasis added.)

22. Section 17(1)(b) of the Ordinance further provides:

> ' *(1) For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of –*
>
> *(a) …*
>
> *(b) subject to section 16AA, any disbursements or expenses not being money expended for the purpose of producing such profits …*' (Emphasis added.)

Zeta's case

23. The Appellant submits that the present case is very similar to the case of Zeta Estates Ltd v CIR (2007) 10 HKCFAR 196 ('Zeta's Case'). The Appellant further suggests that Zeta's Case lays down the principle that if one looks at the balance sheet of any company and it has current liabilities, then provided that the liquid assets are not sufficient to discharge the current liabilities then any loan to the tune of the liabilities would justify interest deduction.

24. The Respondent asserts that to claim a deduction of interest payment under section 16(1)(a) of the Ordinance (and to avoid having such a claim being excluded under section 17(1)(b) of the Ordinance), the taxpayer must show that he borrowed the loan (on which the claim for interest payment deduction is made) for the purpose of 'producing his profits'.

25. It is common ground that the word 'producing' is not to be given a restricted, literal meaning, and can cover the scenario where the purpose of the borrowing was to maintain an existing profit producing capacity: Zeta's Case at 205E per Lord Scott NPJ. Nor is it necessary that the borrowing be wholly or exclusively for the purpose of producing profits: Zeta's Case (supra) at 210C-D.

26. Central to the parties' contention is the interpretation to be put on Zeta's Case. In Zeta's Case, Lord Scott of Foscote NPJ (with whom the other judges agreed) delivered the judgment. In support of their respective cases, counsel for each party drew our attention to separate passages of the Zeta's Case. Putting them together would make it easier to see the context in which the various passages relate. These passages are in the following paragraphs of that judgment:

26.1. Page 204 letter G to page 205 letter A '*The Board's factual conclusions, in my opinion, indicate some misunderstanding about the concept of "working capital" … … "Working capital" is a term used to describe the capital employed in a business in order to produce the profits in 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 the profit-earning state 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))*'

26.2. Page 205 letters B to D paragraph 15 '… *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 section 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.*' (Emphasis added.)

26.3. Page 205 letters D to E paragraph 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.*'

26.4. Page 206 letters G to I paragraph 18: '***It was reasonable for the Board to regard the dividend declaration and loan 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 … accepted*** ***in their***

> ***evidence that that was so***. … *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 loan was to fund the payment of the dividends. That, too, was too obvious to require to be established by evidence.*' (Emphasis added.)

26.5. Page 207 paragraphs 19 and 20: '*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 dividend to be funded. Zeta had only two ways of doing so … to sell … or … to borrow …That these were Zeta's only options is apparent from its 1998/1999 accounts* … [20] *In my opinion, the Board's … 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.*'

26.6. Page 210 at letters C to D paragraph 25: '*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.*'

27. It is important to note paragraph 19 of the Board's decision in Zeta's case that '*The Board concluded that the loans were obtained for the purpose of paying the dividends and interest expenses were therefore attributable to the dividend payment …*'. (See D34/04 paragraph 19 and [2006] HKCA 79 at paragraph 11). This finding forms the basis of Lord Scott of Foscote NPJ's judgment referred to in paragraph 26.4 herein. In the present case, whether that is so is the very bone of contention between the parties.

Appellant's contention

28. The Appellant's case, as discerned from paragraphs 7 to 15 of its Skeleton Argument, can be summarized as follows:

28.1. The Appellant was indebted to Mr D and Ms E (its two shareholders) as at 31 March 1998 by reason of dividend declared at that year end.

28.2. On or about 30 April 1998, the Appellant borrowed a loan from Company B to discharge its debts to Mr D and Ms E.

28.3. For each financial year that followed, the Appellant paid interest to Company B for the loan advanced from Company B.

28.4. During the year ended 31 March 2004, the loan from Company B to the Appellant was refinanced (i.e. repaid) by another loan taken out by the Appellant with the Bank C.

28.5. The Appellant had insufficient liquidity to repay the loan from Company B and Bank C. If repayment was to be effected, the Appellant would have to sell its income-generating real estate properties.

28.6. The purpose of the Appellant's borrowing from Bank C (on which it now claims interest payment deduction) was 'to maintain an existing profit producing capacity', which falls within section 16(1)(a) of the Ordinance.

29. The Appellant further contents

29.1. that in the Zeta's Case, the taxpayer used the loan to discharge its obligation to pay dividend (which is the most extreme case of non-profit producing purpose).

29.2. that The Court of Final Appeal found in favour of Zeta's Case, saying section 16 of our Inland Revenue Ordinance, only requires the profit producing purpose to be one of the purposes (even a collateral purpose); and it does not have to be the sole or exclusive purpose.

29.3. that despite that the Appellant does not have very clear evidence on what exactly those funds borrowed from Bank C had been put to, but it is indisputable that in using those funds to whatever purpose that they had been put to, loans had been taken out from Bank C instead of selling the company's profit generating assets.

29.4. that if one looks at the relevant years' final financial statements, without the loans, it's indisputable that without the loans profit generating assets have to be sold. And in that sense Zeta's Case is applicable.

29.5. that if one looks at the balance sheet of any company and it has current liabilities, then provided that the liquid assets are not sufficient to discharge that loans taken out any loan to the tune of the liabilities would justify interest deduction.

The Respondent's Case

30. The Respondent contents as follows:

The Appellant's indebtedness to its two shareholders

30.1. The Appellant's financial statements for the year ended 31 March 1998 showed the following:

(a) dividend declared and paid: HK$20 million; and

(b) amount due to directors: increased to HK$18,491,076.93 from HK$5,003,316.01 as at the previous year end.

30.2. There is nothing to correlate the declared dividend with the amount due to the directors, particularly when the dividend was recorded to have been 'paid'.

Purported loans from Company B

30.3. The Appellant claimed that Company B borrowed a HK$25 million loan from Bank G, made available in two tranches of HK$10 million and HK$15 million on 30 October 1997, and was re-lent to the Appellant on the same terms as stipulated by Bank G.

30.4. There is nothing to correlate the purported HK$25 million loan from Company B to the Appellant's payment of HK$20 million dividends to its two shareholders at the year ended 31 March 1998:

(a) It is unclear as to exactly when (if at all) Company B purportedly lent the Bank G loan to the Appellant.

(b) The Appellant declared and paid the HK$20 million dividends by the year ended 31 March 1998, but the purported loan from Company B was only recorded in the financial statements for the next year end.

(c) On the other hand, if Company B re-lent the Bank G loan to the Appellant in October 1997 (when Company B itself got the loan from Bank G), no interest expense or income was recorded in the financial statements of the Appellant and Company B respectively for the year ended 31 March 1998.

30.5. There was no written loan agreement between the Appellant and Company B for the purported loan. The Board Minutes of Company B dated 24 October 1997 purporting to authorize the 're-lending' of the loan from Bank G to the Appellant was dubious, given one of the directors, Mr D, could not have been at Company B's registered office in Hong Kong on that day (as the minutes recorded) given he had entered Country H on 12 October 1997 for a heart surgery in City J in November, and did not return to Hong Kong until late-December.

30.6. There was no actual fund movement between the Appellant and Company B for the purported loan. In other words, it was Company B that retained and used the HK$25 million loan from Bank G at all times.

30.7. There is no evidence as to how the HK$25 million loan has been applied. There is no evidence that it was used to pay dividends to the shareholders as the Appellant now seems to be contending, and the Appellant previously claimed the loan was used 'for operating purpose' or used 'to finance the [Appellant's] working capital and property upgrade'. This also took the present case away from Zeta Estates Ltd (supra) where there was evidence that the amount of dividend payable to each shareholder was treated as a loan at a commercial rate of interest by that shareholder to the taxpayer, and the taxpayer's liability to pay dividend was, in turn, agreed to be treated as discharged by the shareholder's loan. (see page 201F)

30.8. Even if the Appellant did borrow HK$25 million from Company B to pay dividends to its two shareholders, only HK$20 million of dividends was declared and paid. There is no evidence as to how the remaining HK$5 million has been applied.

30.9. The loan from Company B to the Appellant was purportedly increased from HK$25 million to HK$30 million on 30 September 2000 and such further loan appeared to be effected a credit entry in the Appellant's accounts of HK$7.5 million from Company B, HK$2.5 million of which was 'repayment' by Company B to the Appellant to cover the same amount by the Appellant to Bank G on behalf of Company B earlier. There is no evidence of the purpose of the Appellant borrowing from Company B such further HK$5 million loan, or how the same was applied.

30.10. Crucially, the Respondent previously determined, in the 2007 Determination in respect of the additional profits tax assessment of the Appellant for the years of assessment 1997/98 to 2002/03, that:

(a) the purported loan from Company B was an artificial transaction which reduces the Appellant's profits and hence tax liability, and was thereby disregarded under section 61 of the Ordinance;

(b) the purported loan from Company B was also a transaction entered into for the sole or dominant purpose of enabling the Appellant to obtain a tax benefit within the terms of section 61A of the Ordinance, and should be disregarded; and

(c) the claim for deduction of interest payments purportedly paid to Company B by the Appellant were therefore all disallowed.

30.11. The Appellant did not appeal against the 2007 Determination. Absent any fresh evidence, then by reason of parity of reasoning, it is not open to the Appellant to now allege that the loans from Company B did exist or it had been paying interest expenses to Company B over the years for 'servicing the loans from Company B' (paragraph 10 of the Appellant's Skeleton Argument) contrary to the previous adverse 2007 Determination.

Loan from Bank C

30.12. On 30 March 2004, Bank C appeared to have credited the Appellant's account in the sum of HK$30 million.

30.13. There is no evidence that:

(a) the Appellant had to repay HK$30 million to Company B;

(b) Company B had demanded the Appellant for repayment of HK$30 million;

(c) HK$30 million was transferred to Company B's bank account at any time;

(d) the Bank C loan 'substituted' the purported loans from Company B.

30.14. Indeed, the Appellant claimed that Company B had repaid its loans from Bank G partly from the sale proceeds of a Hong Kong office premise, and partly by a loan from an associated company in Country H.

30.15. It was also the Appellant's own contention that part of the additional loan raised by the Appellant from Bank C for the year 2006/07 was lent to Company B for (the Appellant's) investment purposes whereby the loan interests (received from Company B) were recapped back as the Appellant's income and formed its assessable profits. However, the Appellant's financial statements for the year ended 31 March 2007 stated that the amounts due from Company B are 'non-interest bearing' (note 10); whereas the financial statements for the next year end (31 March 2008) stated that only the first HK$10.5 million loan due by Company B carry interest at HIBOR plus 0.625% 'on a back-to-back

basis with the corresponding bank loans', and the residual amount is non-interest bearing (note 11).

30.16. In short, there is no evidence to show how the loan from Bank C was borrowed for the purpose of producing the Appellant's assessable profits.

Interest payments

30.17. There is no evidence that the two sums claimed by the Appellant as deduction for interest payments (HK$368,749 and HK$1,006,734) were indeed expenses made by the Appellant to Bank C in respect of loan from Bank C:

(a) As to HK$368,749 claimed for the year 2004/05, the Appellant's financial statements for that year end did not identify the recipient of that sum which was merely booked as 'loan interest'. The Appellant failed to provide any information on the said sum despite queries from the Respondent on 19 January 2011 and 4 April 2011.

(b) As to HK$1,006,734 claimed for the year 2006/07, there is only the bare assertion from the Appellant to the Respondent that it was 'interest on loan from Bank C loan'. No bank statement, payment voucher or records of any kind has been produced by the Appellant.

31. The Respondent further contends:

31.1. The passage in Zeta's Case in paragraph 26.2 herein, Lord Scott, in effect says this, the wisdom of a company declaring and paying dividends is not a matter for the court as long as it can be shown that the actual purpose of the loan was to pay dividend, and to borrow the loan would save the company from selling its profit generating assets, that would be sufficient to fall within section 16 of the Ordinance.

31.2. So the passage is to this effect: one does not ask the wisdom of certain transaction, that is not a matter for the Board or for the court, but one only needs to ask why the capital was raised because section 16(1)(a) and also section 17(1)(b) expressly requires the interest expense to be paid for a loan made for the purpose of producing profits. One still need to ask and answer the question why the loans were raised, even though the wisdom of doing this is not a matter for the Board or the court.

Discussions and findings

Loans and why

32. We note the observations of Lord Scott in Zeta's Case in paragraphs 26.4 and 26.5 herein are made in the context of the evidence of the witnesses and the board findings referred to therein.

33. We are of the view that the Appellant's formulation set out in paragraph 23 is too wide. Absent a finding as the Board in Zeta's Case did '*that the dividend declaration and loan as a single transaction in the sense that but for the dividend declaration the loans would not have been needed*' where correlated the loan to the perseverant of the need for fresh working capital, one does not merely look at the balance sheet of a taxpayer as suggested by the Appellant. One needs to ask 'why' the loan was incurred [See paragraph 26.2 herein] and consider the evidence and not just the arguments proffered in explanation.

34. In the present case before this Board, despite the Respondents previous requests for information to which no reply was given [See paragraphs (4)(b)(i), (12) and (15) of the agreed facts set out in paragraph 17 herein] and

34.1. neither the directors not the auditors were called to give evidence.

34.2. there is no evidence of the demand for repayment.

Interest payments

35. We agree that there is no evidence that the two sums claimed by the Appellant as deduction for interest payments (HK$368,749 and HK$1,006,734) were indeed expenses made by the Appellant to Bank C in respect of loan from Bank C:

35.1. As to HK$368,749 claimed for the year 2004/05, the Appellant's financial statements for that year end did not identify the recipient of that sum which was merely booked as 'loan interest'. The Appellant failed to provide any information on the said sum despite queries from the CIR on 19 January 2011 and 4 April 2011.

35.2. As to HK$1,006,734 claimed for the year 2006/07, there is only the bare assertion from the Appellant to the CIR that it was 'interest on loan from Bank C bank loan'. No bank statement, payment voucher or records of any kind has been produced by the Appellant.

36. Illiquidity as at the annual balance sheet dates before and after any transaction is not the same as actual illiquidity at the time of the particular transaction. In audited financial statements, all liabilities which are due within 12 months are classified together as current liabilities. However, unless one has sight of a cash flow statement or cash flow projection on a day to day basis one would not know whether there is any actual cash need as

at the day of any particular transaction. The situation is more dubious especially in view of the failure to produce evidence correlating the loans with the cash flow obligations even when asked.

37. In short, we are not satisfied

37.1. that the borrowing of the loan by the Appellant from Company B on or about 30 April 1998 was for the purpose of discharging its debts to Mr D and Ms E as contended by the Appellant; nor

37.2. that the Appellant had insufficient liquidity to repay the loan from Company B and Bank C; nor

37.3. that the purpose of the Appellant's borrowing from Bank C (on which it now claims interest payment deduction) was 'to maintain an existing profit producing capacity'.

38. The appeal is therefore dismissed and it is not necessary for us to decide on the Respondent's contention on sections 61 and 61A.

Sections 61 and 61A

39. Insofar as may be necessary, the Respondent further contends that section 61 and section 61A of the Ordinance applies, as follows:

39.1. First, the two sections apply to disregard the purported HK$30 million loan from Company B to the Appellant, for the reasons set out in the 2007 Determination, and this takes away the bedrock upon which the Appellant's present claim for deduction of interest payment in respect of the Bank C loan is made.

39.2. Second, section 61A also applies to the Bank C loan:

(a) One can compare the situation immediately before and after the Bank C loan was drawn down.

(b) If the Bank C loan was not drawn down on 30 March 2004, the Appellant had to continue to pay 'interest' to Company B which it would not have been able to succeed in claiming any interest payment deduction, for the reasons set out in the previous 2007 Determination.

(c) It is likely that the Respondent's letter of 19 March 2004 for tax audit to the Appellant prompted the Appellant to draw down the loan from Bank C given the Appellant could not produce the

evidence for the loan from, and interest payment to, Company B, as CIR requested.

(d) The sole or dominant purpose for the Bank C loan was therefore for the tax benefit of claiming interest deduction under profits tax:

1. In form, the Appellant borrowed the Bank C loan to repay Company B. In substance, however, the Appellant never had any legal liability to repay Company B.

2. The Appellant tried to obtain the tax benefit in respect of the related interest deduction of the Bank C loan.

3. Had Company B borrowed the loan itself, it could not have the immediate tax effect of interest deduction since it had a huge amount of accumulated loss over the years.

4. Viewing Company B and the Appellant as a whole (since they are owned and controlled by the same persons), the whole group can enjoy immediate tax benefit if it was the Appellant, which is a paper profitable company, which claim interest deduction.

5. In short, the Appellant claims deduction of interest and enjoys the tax benefit immediately. But it did not obtain the loan for its own use and assumed a liability to pay principal and interest.

6. Further, for 2006/07, the comparison could also be made between

   (A) not obtaining additional loan from Bank C, and

   (B) drawing down further loan from Bank C and re-lending to Company B.

   Had Company B applied for the loan itself, it could not have tax effect of the interest deduction in view of its loss position (HK$29 million losses brought forward from 31 March 2006 and loss of HK$16 million for 2006/07). On the other hand, there would be tax saving of the Appellant by claiming the interest payment deduction, if the Appellant applied for the loan.

40. In other words the Respondent contended that the following transactions are to be disregarded:

40.1. The borrowing of HK$30 million from Company B

40.2. The entering into a loan agreement of HK$30 million with Bank C

40.3. Purported repayment of HK$30 million to Company B

40.4. Purported increases of loan borrowed from Bank C

41. The Appellant contends that presence of tax benefit is an essential condition for section 61A of IRO to apply:

41.1. In Ngai Lik Electronics Co Ltd v CIR (2009) 5 HKLRD 334, at paragraph 34, per Ribeiro PJ; Three intersecting conditions must be satisfied before the Commissioner can exercise her power to raise an assessment under section 61A(2). They are that:

(a) a transaction (broadly defined to include an operation or scheme) has been entered into;

(b) such transaction has, or would have had but for this section, the effect of conferring a tax benefit on the relevant person (that is, on the taxpayer against whom the section has been invoked); and

(c) viewing the transaction through the prism of the seven matters enumerated in section 61A(1)(a)-(g), it would objectively be concluded that it was entered into or carried out for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit.

41.2. In Shui On Credit Co Ltd v CIR (2009) 12 HKCFAR 392 at paragraphs 6, 47 and 48, per Lord Walker.

(a) At the beginning of this judgment, I referred briefly to the question whether section 61A can have any application to a tax avoidance scheme which (in colloquial terms) simply does not work and indicated that it cannot apply, so answering the question that had been left open in Ngai Lik Electronics Co Ltd v Commissioner of Inland Revenue. The logic of the argument is that liability under section 61A presupposes non-liability in the absence of section 61A. Otherwise there would be no benefit in the statutory sense.

(b) In Commissioner of Inland Revenue v HIT Finance Ltd, paragraph 15, Lord Hoffmann NPJ made some observations which might be thought to imply (though they certainly did not express) a contrary view. Any observations of Lord Hoffmann NPJ are entitled to great respect, but it is to be noted that in that case the company referred to as Finance was not held liable under section 61A, and the company referred to as HITL (which was liable under section 61A) was not attached under sections 16 and 17 until the case reached the Court of Appeal. I do not think Lord Hoffmann NPJ's observations can be regarded as a considered contrary conclusion.

42. The Appellant further submits that

42.1. the same is equally true for section 61 of IRO, which requires of the subject transaction to be one '… *which reduces or would reduce the amount of tax payable by any person.*…'

42.2. The loans themselves and their successive swapping with one another as set out in paragraphs 39.2 and 40 herein did not and simply could not create any tax benefit within terms.

42.3. The identified tax benefit and the challenged transaction must be properly aligned with precision: Ngai Lik Eletronics Co Ltd v CIR, *op. cit.*, at paragraph 36, per Ribeiro PJ. Here, the fact remains that interest is nonessential to a loan and is merely collateral. It is wrong in principle to disregard the loans on the sole basis of the chargeable interest; they do not properly align.

42.4. In any event, it is also for the Respondent to demonstrate who on Earth in his right mind would purposely obtain a tax benefit by incurring and paying to an extra-group third party even more that far outweighed such benefit – here for every 17.5 cents of tax liability reduction, it would have to actually suffer an interest payment to Bank C of 1 dollar.

42.5. Further, it is submitted that anti-avoidance provisions such as sections 61 and 61A do not apply to reduction of tax liability arising from reduction of income or incurring of additional expenditure: see IRC v Challenge Corporation Ltd [1987] AC 155, at 167H, per Lord Templeman.

43. As to the Appellant's point in paragraph 42.3 herein, the Respondent submits, and we agree, that the sections is engaged where there is a resultant tax benefit to 'any person'. The person in the present case being Company B. If the loan is needed by Company B in any event, then the 17.5 cent is incurred in any event.

44. As to the Appellant's last point in 42.4 herein, it is true that Lord Templeman who delivered the majority decision of the House of Lords did say

> 44.1 '[Page 167 bottom paragraph] *Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability. Section 99 does not apply* to *tax mitigation because the taxpayer's tax advantage is not derived from an "arrangement" but from the reduction of income which he accepts or the expenditure which he incurs*'.
>
> 44.2 [Page 168 Letter s D-E] '*Section 99 does not apply to tax mitigation where the taxpayer obtains a tax advantage by reducing his income or by incurring expenditure in circumstances in which the taxing statute affords a reduction in tax liability.*'

45. However, we note that the wordings of NZ sections 90 and 191 are rather different from our section 61A. Section 99 is headed 'Agreements purporting to alter incidence of tax to be void' and, so far as material, provided in the relevant income tax year ended 31 March 1978 as follows:

> ' *(1) For the purposes of this section – "Arrangement" means any contract, agreement, plan, or understanding (whether enforceable or unenforceable) including all steps and transactions by which it is carried into effect: "Liability" includes a potential or prospective liability in respect of future income: "Tax avoidance" includes - (a) Directly or indirectly altering the incidence of any income tax: (b) Directly or indirectly relieving any person from liability to pay income tax: (c) Directly or indirectly avoiding, reducing, or postponing any liability to income tax. (2) Every arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the commissioner for income tax purposes if and to the extent that, directly or indirectly, - (a) Its purpose or effect is tax avoidance; or (b) Where it has two or more purposes or effects, one of its purposes or effects (not being a merely incidental purpose or effect) is tax avoidance, whether or not any other or others of its purposes or effects relate to, or are referable to, ordinary business or family dealings, - whether or not any person affected by that arrangement is a party thereto. (3) Where any arrangement is void in accordance with subsection (2) of this section, the assessable income and the non-assessable income of any person affected by that arrangement shall be adjusted in such manner as the commissioner considers appropriate so as to counteract any tax advantage obtained by that person from or under that arrangement*'.

46. Even applying the general principles one is confronted with the notion of whether it is artificial. We say it is.

47. In so far as it is necessary to resort to sections 61 and 61A, we find that transactions in paragraph 40 herein are to be ignored.

Conclusion and disposal

48. The appeal by the Appellant is dismissed. We confirm the assessment in the Determination and wish to thank both counsel for their helpful assistance.