Case No. D15/16

Profits tax – likelihood of recoverability – single specific or various debts – the word 'and' in the two limbs of the proviso – knock on effect of the loss – section 16(1)(d) of the Inland Revenue Ordinance ('IRO')

Panel: Chan Chi Hung SC (chairman), Chow Lap San Edward and Anson Wong SC.

Dates of hearing: 21 to 22 January 2016.
Date of decision: 8 July 2016.

The taxpayer, a wholly owned subsidiary of Company A, is in the business of money lending, earning interest as its income. Company A, together with 4 other companies, entered into a Joint Venture Agreement with Company D to finance the latter by loans. Company A's obligation to lend to Company D was satisfied by a loan from the taxpayer. The Determination by the Deputy Commissioner disallowed the whole of the claim by the taxpayer of a provision for bad debt for the perceived inability to recover the outstanding principal and interests from Company D, for the purpose of its profits tax computation for the year ending 30 June 1999. The aforesaid provision, if allowed, will have a knock on effect on the amount of profits tax payable for subsequent tax years. The Deputy Commissioner decided that the provision (for both principal and interests) could not be within the 2nd limb of proviso (i) to section 16(1)(d), as the loan was not in the ordinary course of the taxpayer's business, it not being on arms-length commercial terms if one looks at the unusual terms of the Loan. The Respondent also argued that the provision sought to be allowed was a general provision for a number of debts rather than a specific provision for a specific debt and thus not allowable on a proper construction of section 16(1)(d). Counsel for the taxpayer, at the hearing, narrowed the scope of this appeal only to the provision for the irrecoverable interests and not the principal, and did not seek to justify the provision by reference to the 2nd limb, but argued solely on the basis of the 1st limb of Proviso (i). The contested issue in this appeal concerns the interest element of the doubtful debts owed to the taxpayer by Company D. The Respondent referred the Board to the fact that (a) a further loan was lent by the taxpayer to Company D after making the provision for doubtful debt in 1999; and (b) the taxpayer had never sued Company D, nor taken any step to enforce the debt and the notes to the audited account of Company D for the year ending June 1999 stated: 'The financial statements have been prepared on a going concern basis because the shareholders have agreed to provide adequate funds for the Company to meet its liabilities as they fall due'. The taxpayer argued that if Company D did not have sufficient asset, it being of limited liability as a corporation, how much could suing Company D or winding up Company D help to eventually recover the debt.

Held:

1. Whether a doubtful debt should be estimated as having become bad is a question of fact. Apart from the requirement that the provision for estimated bad debt must be made *bona* fide by the taxpayer, the test is objective, with the burden of proof on the taxpayer. The test has been formulated as, not being 'merely a situation of deferred payment', but 'the circumstances must indicate to a reasonable and prudent business person, that, on a balance of probability, the debt is unlikely to be recovered.'

2. The fact that a further loan was lent is not decisive by itself. It must be weighed together with other facts and evidence with respect to the issue of likelihood of recoverability. The Board must bear in mind that the forensic exercise is not so much the determination of the strict legal/contractual rights and obligations between Company D and the taxpayer, but rather the ultimate fact as to the likelihood of recovery of the debt or the relevant part of it. The taxpayer's explanation on not suing Company D makes much commercial sense, from a pragmatic angle in the factual context. The notes to the audited account is a 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, 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 Company D so that its liquidator will enforce that 'agreement' ('…shareholders have agreed to provide…'), this Board finds that there was no undertaking given to Company D (as opposed to the auditor) and that any such undertaking, if given, is not enforceable as too uncertain or for lack of good consideration. Furthermore, the relevant ultimate issue is a rather objective assessment of recoverability of the debt by a prudent and reasonable person. The prudent view should be that there is a substantial risk that it might not be an undertaking to Company D at all, and the blank cheque is probably not legally binding on the shareholders for uncertainty or lack of good consideration. Considering and balancing all the aforesaid facts and evidence, it is the firm view of this Board that, by the state of play as viewed in June 1999, it was quite clear that the amount of debt owed to the taxpayer was quite unlikely to be recovered by the taxpayer, in the view of a reasonable and prudent man.

3. The Respondent's submission on the point of 'general provision' seems to include an argument that if a single general non-specific provision is made for various debts incurred in different occasions or circumstances or at various times, the likelihood of recovery will vary a lot depending on the different circumstances pertaining to the different debts, and a taxpayer should not be regarded as having proved that the general non-specific provision is justified (in the sense of proving the likelihood of non-recovery). However, the whole sum claimed consists of only all the accrued or charged interests owed from one single entity (Company D), pursuant to one loan, albeit drawn in tranches at stages). Alternatively, assuming that

they were different loans, but they were lent for a single development project pursuant to Company A's obligations under one joint venture or the Joint Venture Agreement.

4. The Respondent argued that once the debt (interests portion) arose out of money lent, then it had to fulfil the requirement of the 2^{nd} limb to qualify for a deduction, and that a deduction should not be allowed even though it might qualify under the 1^{st} limb. This Board holds the view that on proper construction of section 16(1)(d) and its proviso, the provision for the irrecoverable interests should be allowed if it comes within the 1^{st} limb and within section 16(1)(d) even if (assuming without deciding) it was not within the 2^{nd} limb of the proviso. The 2 limbs of the proviso are connected by the word 'and', but clearly in the disjunctive or alternative sense and not in the conjunctive sense, as the 1^{st} limb has a distinct and important requirement: 'included as a trading receipt'. If this important and distinct requirement is met, there is no reason why the 2^{nd} limb must also be satisfied.

5. The taxpayer only argued for provision for the year ending June 1999 and did not seek further provision or revolving provisions in the following years, but just relied on the knock on effect of the loss resulting from the allowance of deduction for the provision, and the carried down loss (in so far as not fully absorbed by the otherwise profits of the corresponding years) to some of the subsequent years where there would have been profits if they were calculated without such carried down loss. Thus, once the contention of the taxpayer is upheld for the year ending June 1999, the tax payable for some of the subsequent years will also have to be revised accordingly.

Appeal allowed.

Cases referred to:

Graham v Commissioner of Inland Revenue (1995) 17 NZTC 12
Dinshaw v Bombay Income Tax Commissioner (1934) 50 TLR 527
Commissioner of Inland Revenue v County Shipping Co Ltd 3 HKTC 267

Yvonne Cheng, Senior Counsel, instructed by Messrs Baker & McKenzie, for the Appellant.
Richard Fawls, Counsel, instructed by Department of Justice, for the Commissioner of Inland Revenue.

Decision:

Background and facts

1. The Appellant/the Taxpayer is a wholly owned subsidiary of Company A. Both the Taxpayer and Company A are members of the Company B's group of companies. Company B is one of the well-known property developers in Hong Kong.

2. The Taxpayer's principal business was and is money lending, earning interest as its income.

3. In about 1993, 5 of the well-known property developers in Hong Kong entered into a joint venture for a residential development on a site in Region C. The corporate vehicle purpose built to carry out the joint venture was Company D, a company incorporated in Hong Kong in August 1993. Company D did not have any other business apart from this joint venture. Company B used Company A as its corporate vehicle through which to participate in the joint venture, Company A becoming a 10% shareholder of Company D. The Company B group did not have control of Company D as Company A was (and is) a minority shareholder (this has a bearing on the reliability of the audited or management accounts of Company D, which are relied on by the Taxpayer for the purpose of this appeal).

4. The site for the development was acquired by Company D by auction in December 1993.

5. Company A entered into a Joint Venture Agreement dated 7 May 1996 in respect of the joint venture, with Company D and the relevant corporate vehicles (which were the other 4 shareholders of Company D) used by the other 4 developers. The Taxpayer is not a party to the Joint Venture Agreement. From the facts set out in paragraph 4 above and paragraph 7 below, the joint venture was carried out since, at the latest, December 1993, several years before the Joint Venture Agreement was entered into. Neither the Taxpayer nor the Respondent suggests that apparent time gap will affect the determination of any issue in this appeal. The Taxpayer's witness Mr E (a director of the Taxpayer and Company A) stated in his witness statement (adopted as his evidence) that the terms of the Loan advanced (see paragraph 7 below) 'were subsequently formalised in the Joint Venture Agreement'.

6. Under the Joint Venture Agreement (clause 6.1), the development cost, in so far as external finance was not available, was to be financed by loans from the 5 shareholders of Company D according to the 'Agreed Proportions' (10% in the case of Company A, or pro-rata to their respective shareholdings in Company D).

7. Company A's obligation to lend under clause 6.1 was (or had been) satisfied by a Loan from the Taxpayer to Company D (there is a disagreement between the Taxpayer and the Respondent as to whether it was one loan drawn in tranches or several loans). Draw-down began on 15 December 1993 ($15 million) (see the Taxpayer's Loan

Account with Company D at Appendix B of the Determination). According to the profit and loss account of the Taxpayer, interests on the principal drawn for the Loan were charged by the Taxpayer against Company D.

8. Clause 10.3 of the Joint Venture Agreement provides that the sale proceeds from Company D should go to repay, *inter alia*, fourthly the principal, and then only fifthly, interest, in that priority (the Taxpayer and Respondent has difference as to whether that clause, or the Joint Venture Agreement as a whole, is relevant to the issues in this Appeal: the Respondent emphasized the undisputed fact that the Taxpayer has never been a party to the Joint Venture Agreement).

9. As a fact (which this Board so finds), interests were indeed charged by the Taxpayer against Company D on the basis that all payments from Company D to the Taxpayer had been for repayment of the principal only and not payment of interest (e.g. see Exhibit A-1, 'concealed by the Board of Review' therein being a mistake when it should be referring to the Taxpayer; and see the Taxpayer's loan account with Company D at Appendix B of the Determination), and Company D and the other 4 lenders also conducted themselves on that basis (Note: payments of varying amounts were made by Company D to the Taxpayer from 1996 to 1999; the payments after 1999 are irrelevant to this issue as the Loan was interest free after 17 January 1999).

10. The Taxpayer was assessed and the Taxpayer paid profits tax on such interests for the years ending (30 June) 1994, 1995, 1996, 1997, 1998, and 1999 (interest free after 17 January 1999), on the basis that such interests were the chargeable incomes of the Taxpayer, calculated as aforesaid (thus, being on accrual and not cash basis).

11. Under the Joint Venture Agreement clause 11.1, all the units in the development 'shall be sold and be offered for sale by not later than the date of the issue of the occupation permit…'. This clause might or might not (which is not necessary to be decided here) be a reason for the fact that, notwithstanding the general downturn of the Hong Kong residential property market during the Asian financial crisis since about 1998, Company D had sold the bulk of the units of the development by June 1999 at a huge loss, rather than waiting for a future recovery in the property market. Looking at the monthly figures of the Property Market Statistics (the tables under 'Private Domestic-Average Prices by Class') published by the Rating and Valuation Department for the years 1999 to 2015, and as a general background, by and large there was substantial recovery in the property prices of Region C residential units only by 2005 onward, but not earlier.

12. Clause 12.1 of the Joint Venture Agreement provides for in-specie distribution of the units of the development by Company D to its shareholders as dividends, if the units still remain unsold 12 months after the issue of the certificate of compliance. In view of the loss mentioned above (and thus no dividend is payable), this clause has little significance in the present factual context.

13. By June 1999, despite some repayments as aforesaid from the sale proceeds of the units, the outstanding principal plus interest outstanding and due to the Taxpayer from Company D amounted to a huge sum of about $399 million.

14. On the other hand, due to the aforesaid downturn in the property market and the sale of the bulk of the units of the development at a loss, the net asset value (not taking into account the loans by the shareholders or their associated companies) of Company D (mainly assets on a mark-to-market basis based on the professional valuation of the remaining unsold units), according to the balance sheet of Company D as of 30 June 1999, was much less than the outstanding loans and interests owed by Company D to the Taxpayer and the other 4 lenders.

15. Thus, the Taxpayer claimed a provision for bad debt for the perceived inability to recover the outstanding principal and interests from Company D, for the purpose of its profits tax computation for the year ending 30 June 1999.

16. The aforesaid provision, if allowed, will have a knock on effect on the amount of profits tax payable for the years ending June 2002, 2003, 2004, 2005 and 2006 (because the loss resulting from such allowance in 1999 would be carried forward to later years: see the table prepared by Miss Cheng SC and reproduced as Appendix hereto). The assessments in respect of the years ending June 2000 and 2001 are not in dispute (mainly for the reason that no profits tax has been assessed in respect of them in any event).

17. The Determination by the Deputy Commissioner disallowed the whole of the claimed provision for 1999, and also upheld the assessments for the other relevant years on the basis of no such provision. (Note: provisions were allowed by the Assessor, after objections by the Taxpayer, in respect of the doubtful debts in relation to the 2nd mortgages, resulting in revision by the Assessor of the Profits Tax Assessments for the years ending June 2004 and 2006, which were confirmed by the Determination. These do not form any part of the subject matter of this appeal.)

18. By the Notice of Appeal, the Taxpayer appealed to this Board of Review against the Determination which disallowed the provision as bad debts for the outstanding principal and interests. In her written opening submissions for the Taxpayer, Miss Yvonne Cheng SC narrowed the scope of this appeal, confining herself to the argument that provision should be allowed for the outstanding interests only, dropping the appeal against the disallowance for the bad debt in relation to the outstanding principal.

Analysis

19. The burden of proof is on the Taxpayer to show that the Determination as to the tax payable is wrong or excessive.

Whether unlikely to be recovered

20. The contested issue in this appeal concerns the provision of bad debts (or doubtful debts estimated to have become bad) in the profit and loss accounts of the Taxpayer for the year ended June 1999, for the interest element of the doubtful debts owed to the Taxpayer by Company D, which the Respondent has disallowed.

21. The relevant legislative provision is Inland Revenue Ordinance Chapter 112 ('IRO') section 16(1)(d), and its proviso (i): '*In ascertaining the profits…there shall be deducted …(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;* '

22. IRO section 16(1)(d) proviso (ii) should also be reproduced here, as it is relevant (see Graham v CIR (1995) 17 NZTC 12 at 110) to the interpretation of what is '*…doubtful debts…estimated to the satisfaction of the assessor to have become bad…*': '*(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;* '.

23. Whether a doubtful debt should be estimated as having become bad is a question of fact: Dinshaw v Bombay Income Tax Commissioner (1934) 50 TLR 527. Apart from the requirement that the provision for estimated bad debt must be made *bona fide* by the taxpayer, the test is objective, the burden of proof being on the taxpayer. The test has been formulated as, not being 'merely a situation of deferred payment', but 'the circumstances must indicate to a reasonable and prudent business person, that, on a balance of probability, the debt is unlikely to be recovered.' (Graham v CIR (1995) 17 NZTC 12, 107 at 110). This Board is of the view that this is the correct test to be applied.

24. Mr Richard Fawls, appearing for the Respondent, referred to the fact that a further loan of HK$200,000 was lent by the Taxpayer to Company D on 1 February 2002, after making the provision for doubtful debt in 1999. He posed the question: why would a creditor risk lending further if the objective circumstances were that the previous debt could not be recovered? Further, would that creditor's assertion that the debt could not be recovered be *bona fide* in such circumstances? Such submission by Mr Fawls is a valid point which this Board has to take into consideration. But this is not decisive by itself. It must be weighed together with other facts and evidence with respect to the issue of likelihood of recoverability. This Board must bear in mind that the forensic exercise is not so much the determination of the strict legal/contractual rights and obligations between Company D and the Taxpayer, but rather the ultimate fact as to the likelihood of recovery of the debt or the relevant part of it (to the extent of about the last $156 million: see paragraph 34 below). Thus, this Board ought to bear in mind the relationship between the Taxpayer, Company A, and Company D, the terms of the Joint Venture Agreement (notwithstanding that it was not legally binding on the Taxpayer as it was not a party, and the fact that the Joint Venture Agreement was signed some years after the Loan began to be drawn), and the factual background matrix of how the Loan came to be lent, as also

valid explanation of why the Taxpayer would still lend notwithstanding the poor state of financial position of Company D.

25. Another fact relied on by the Respondent was that the Taxpayer had never sued Company D, nor taken any step to enforce the debt. The contrary argument is: if Company D did not have sufficient asset, it being of limited liability as a corporation, how much could suing Company D or winding up Company D 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? Mr E so explained when cross-examined by Mr Fawls. Such explanation makes much commercial sense, from a pragmatic angle in the factual context.

26. Mr Fawls referred this Board to the notes to the audited account of Company D for the year ending June 1999: 'The financial statements have been prepared on a going concern basis because the shareholders have agreed to provide adequate funds for the Company to meet its liabilities as they fall due'.

27. 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 (otherwise the auditor might have to conclude that it ceases to be a going concern). Even if one is to push the argument and ask whether the Taxpayer can wind up Company D so that its liquidator will enforce that 'agreement' ('…shareholders have agreed to provide…'), this Board finds that there was no undertaking given to Company D (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 Company D at all, and the blank cheque is probably not legally binding on the shareholders for uncertainty or lack of good consideration. Furthermore, although an arms-length creditor might have cause to complain about being misled by such statement of shareholders' 'agreement' to provide funds, the Taxpayer is certainly not an arms-length party (which the Respondent suggested was the reason why the Taxpayer could not bring itself within the 2nd limb of the IRO section 16(1)(d)(i) and had to abandon the appeal in respect of the provision for the principal). Why would Company A and other shareholders, short of being compellable in law, pay Company D's debts due to the 5 lenders within the same 5 groups of companies? Again, the aforesaid point is not decisive by itself but another factor to be weighed to determine the issue of likelihood of recovery, in the view of a reasonable and prudent business person.

28. The Taxpayer accepts that as of 1999, part of the total outstanding debt due ($399 million) by Company D to the Taxpayer would not be bad or doubtful debt (as Company D's net asset according to the balance sheet of Company D was then still substantial: 10% of it amounted to about $179 million, accepted by Miss Cheng SC as available for repayment to the Taxpayer). The Taxpayer's case is that the shortfall (i.e. $399 million - $179 million = about $220 million) will be the amount of the doubtful debt estimated to have become bad.

29. As noted above, the Company B group did not control Company D, and the reliability of the accounts (in particular the audited ones) of Company D should be considered in this light, and this Board in general accepts them, though not at face value as to the specifically contentious parts. In particular, this Board has to itself guage the value of the units remaining unsold in June 1999, in relation to the issue of ability of Company D to pay its debts.

30. By June 1999, after selling the bulk of the units, the operating loss (i.e. excluding the loss due to revaluation of the stock of unsold units) which had been incurred by Company D was about $1,690 million.

31. The notes to the accounts of Company D for the year ending 30 June 1999 identified in 7 pages each of the unsold units and carparks, which clearly was only a very small proportion as compared to the sold units. Paragraph 33 of Mr E's witness statement summarized the movements of the stock of unsold units held by Company D for the years 1999 to 2004 from the audited accounts of Company D. Thus, as seen in June 1999, at least an immense magnitude of overall loss by Company D (and thus leaving little assets to pay the debts), even by the time all the remaining units were sold later (see the very late significant recovery of the property market which occurred only as late as 2005, viewed in retrospect, set out in paragraph 11 above), was certainly expected to be incurred, as even a substantial increase in the property price in later years would not have changed the big picture (as relevant to the issue of likelihood of recovery of the last $156 million of the debt), due to the small proportion of the units remaining unsold by June 1999.

32. Considering and balancing all the aforesaid facts and evidence, it is the firm view of this Board that, by the state of play as viewed in June 1999, it was quite clear that it was very unlikely that there would be sufficient assets to pay the majority of the debts owed to the 5 lenders to Company D (who were entitled amongst them repayments pro-rata to the amounts of loans from them). In relation to the position *vis-a-vis* the Taxpayer, it was quite clear that there would be a deficit of about $220 million which would be irrecoverable by the Taxpayer. At least, quite clearly the last $156 million (see paragraph 34 below) of the amount of debt of $399 million owed to the Taxpayer was quite unlikely to be recovered by the Taxpayer, in the view of a reasonable and prudent man.

33. Although the correct test as to whether it was allowable doubtful debts should be with regard to the matters as viewed in June 1999 and not retrospectively from matters known in later years, for completeness of discussion, the projected loss of Company D and thus the asset deficit as stated aforesaid was proved by and large correct by subsequent events or facts. The audited accounts of Company D for the year ending June 2014 showed an accumulated loss of about $2,345 million, with a stock of completed (but unsold) properties of about $27 million. The management accounts of Company D for the year ending June 2015 (no audited accounts yet) showed a similar picture. The debt due to the Taxpayer shown in Company D's accounts for both 2014 and 2015 were the same figure of $237,198,283. Thus, the fact that Company D did subsequently repay the taxpayer another substantial sum of $119 million during the year ending June 2000 should be gauged in the context of the aforesaid considerations: that post-June 1999 facts

should be viewed in the aforesaid consideration that the state of play should, strictly, be as viewed in June 1999, and that an examination of repayments subsequent to June 1999 should be at a longer time span e.g. up to 2015 as considered above. Further, the quantum of the repayment in 2000 should be gauged in the context that the Taxpayer is not seeking to justify the whole of the outstanding debt of $399 million as bad debt (paragraph 28 above) as the Taxpayer accepts that $179 million of it should be regarded as retrievable subsequently (thus the repayment of $119 million has been taken account of as part of the contemplated $179 million), and that the Taxpayer is seeking to justify only about $156 million of the $399 million as bad debt (paragraph 32 above and 34 below). As to Mr Fawls' submission about the repayment by Company D to the Taxpayer of a substantial sum of $127 million in the year ending June 1999 (making up a very substantial total repayment of $246 million for the years ending June 1999 and 2000 as Mr Fawls put it in his written closing submissions), it is not helpful at all, as that repayment had already been taken into account in arriving at the total outstanding debt of $399 million (paragraph 28 above). It has never been the Taxpayer's case that there were no substantial repayments by 1999, or that there would be no substantial future repayments. The Taxpayer's case is that the likely post (June) 1999 repayments, objectively assessed, though substantial, should be expected to be hugely insufficient, thus expecting a bad debt of at least $156 million.

34. The Taxpayer's case is that the shortfall (i.e. $399 million debt - $179 million asset = deficit about $220 million) should first be treated as towards Company D's inability to pay the whole of the accrued/charged interest ($156,615,001), and only the remaining balance should be regarded as Company D's inability to pay part of the principal, in relation to the issue of provision for doubtful debts. Looking at it from the other end, if this Board is satisfied that, of the total outstanding debt as in June 1999 of $399 million owed to the Taxpayer by Company D, some of it (about $179 million) could be recovered but the balance $220 million, or at least the last $156,615,001, was unlikely to be recovered on a balance of probabilities as viewed by a reasonable and prudent businessman in June 1999, then the provision for $156,615,001 should be allowed as doubtful debts estimated to have become bad (provided it is within the proviso (i) to section 16(1)(d) IRO, as further analysed in paragraphs 42 to 50 below).

35. Miss Cheng SC relied on the following in support of such of her contention that it was the last $156,615,001 that the Taxpayer needed to prove to be unlikely to be recoverable and that the interest accrued and charged (amounting to $156,615,001, as part of the total debt of about $399 million) over the years up to June 1999 should all be regarded as wholly unpaid by then.

36. Under the Joint Venture Agreement as aforesaid, the sale proceeds should repay the principal first (see paragraph 8 above). Although the Taxpayer was not a party to the Joint Venture Agreement, Company A was. Company A was clearly in control of the Taxpayer (being 100% shareholder), and thus, the other parties could oblige Company A (e.g. by a mandatory order from the court) to perform its obligations under the Joint Venture Agreement by procuring the Taxpayer to do so. As a fact, the Taxpayer and Company D conducted themselves on that understanding and the interests charged were so

calculated. The Taxpayer was assessed and paid profits tax on the interests charged on that basis.

37. This Board is of the view that Miss Cheng was clearly correct, and accepts her contention as set out in paragraph 35 above.

Not deductible for not being specific provision for a specific debt?

38. Mr Fawls argued that the provision sought to be allowed (now limited to the $156,615,001, as interest only) was a general provision for a number of debts rather than a specific provision for a specific debt proved to be bad (or properly estimated to have become bad) for the basis period, and thus not allowable on a proper construction of section 16(1)(d).

39. Mr Fawls' submission seems to include an argument that if a single general non-specific provision is made for various debts incurred in different occasions or circumstances or at various times, the likelihood of recovery will vary a lot depending on the different circumstances pertaining to the different debts, and a taxpayer should not be regarded as having proved that the general non-specific provision is justified (in the sense of proving the likelihood of non-recovery).

40. However, the whole sum of $156,615,001 consists of only all the accrued or charged interests owed from one single entity (Company D), pursuant to one loan (the Loan, albeit drawn in tranches at stages). Alternatively, assuming Mr Fawls to be correct on this, without deciding, that they were different loans, but they were lent for a single development project pursuant to Company A's obligations under one joint venture or the Joint Venture Agreement. The whole sum of $156,615,001 was, properly viewed in the year ending June 1999 and for that basis period, to be likely to be irrecoverable for the single and same reason that the remaining assets of Company D (mainly the mark-to-market value of unsold units of that single development) were deficient due to the downturn in the property market.

41. For the aforesaid reasons this Board wholly rejects the aforesaid submission of Mr Fawls and accepts the contention of Miss Cheng SC, that the claimed provision of $156,615,001 interests should not be disallowed on that alleged ground, but should be allowed (the burden of proof being on the Taxpayer). This Board has no difficulty to, and did, gauge the reasonable businessman's view of likelihood of recovery of the sum of about $220 million deficit, or the $156,615,001 interests, as a single weighing and balancing exercise of one set of facts and evidence as aforesaid, instead of different considerations due to different circumstances pertaining to different debts.

2nd Limb only?

42. As set out in paragraph 21 above, the 2nd limb of the proviso (i) to section 16(1)(d) of IRO referred to (bad) debts in respect of money lent 'in the ordinary course of business'.

43. In the Determination, in dealing with the objection by the Taxpayer in respect of the disallowance of the whole provision of about $220 million, the Deputy Commissioner decided that the provision (which then included both principal and interests) could not be within the 2nd limb of proviso (i) to section 16(1)(d), as the Loan was not in the ordinary course of the Taxpayer's business, it not being on arms-length commercial terms if one looks at the unusual terms of the Loan (for example, the interest rate (as stated under the Joint Venture Agreement) would be solely decided by the board of Company D, and in fact it became interest free after January 1999). The Determination did not separately deal with the interest portion of the provision with reference to the 1st limb of section 16(1)(d) proviso (i).

44. Miss Cheng SC, at the hearing of this Appeal, narrowed the scope of this appeal only to the provision for the irrecoverable interests of $156,615,001 and not the principal, and did not seek to justify the provision by reference to the 2nd limb, but argued solely on the basis of the 1st limb of Proviso (i): '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…'.

45. At the hearing of this Appeal, Mr Fawls raised a new argument against Miss Cheng's reliance on the 1st limb, which was not a reason advanced by the Deputy Commissioner in the Determination (but in fairness, the Taxpayer only dropped the appeal against the disallowance of the provision of bad debt for the principal in Miss Cheng's written opening submission for this appeal). Mr Fawls argued that once the debt (interests portion) arose out of money lent, then it had to fulfil the requirement of the 2nd limb (i.e. in the ordinary course of business) to qualify for a deduction, and that a deduction should not be allowed even though it might qualify under the 1st limb. He argued that, as Miss Cheng SC conceded by dropping her appeal in respect of the principal (which could not be within 1st limb), Miss Cheng SC must have considered that the lending and interest were not in the ordinary course of business of the Taxpayer, and thus not within the 2nd limb of the Proviso.

46. Mr Fawls then sought to distinguish the various authorities relied on by Miss Cheng SC in support of her contention that she could rely on the 1st limb even though the provision for irrecoverable interests was not within the 2nd limb of the proviso.

47. Mr Fawls also submitted that the reasoning in <u>CIR v County Shipping Co Ltd</u> 3 HKTC 267 should be of assistance to his contention of the construction of the proviso to section 16(1)(d). With respect, this Board cannot see any assistance from it at all.

48. This Board agrees with Miss Cheng SC that, on proper construction of section 16(1)(d) and its proviso, the (part of) provision to the extent of $156,615,001 should be allowed if it comes within the 1st limb (and within section 16(1)(d): being bad or estimated to be bad debt), even if (assuming without deciding) it was not within the 2nd limb of the proviso.

49. The 2 limbs of the proviso are connected by the word 'and', but clearly in the disjunctive or alternative sense and not in the conjunctive sense, as the 1st limb has a distinct and important requirement: 'included as a trading receipt'. If this important and distinct requirement is met, there is no reason why the 2nd limb must also be satisfied.

50. The sum of $156,615,001 had been included as a trading receipt (as interest charged), and so assessed, with profits tax paid as aforesaid. That part of the claimed provision is clearly within the 1st limb, and should be allowed as a deduction for the purpose of assessing profits tax for the year ending June 1999, under IRO section 16(1)(d).

The Knock on effect on other years

51. As aforesaid, the Taxpayer only argued for provision for the sum of $156,615,001 for the year ending June 1999. Contrary to the submission of Mr Fawls, the Taxpayer did not seek further provision or revolving provisions in the following years, but just relied on the knock on effect of the loss resulting from the allowance of deduction for the sum of $156,615,001, and the carried down loss (in so far as not fully absorbed by the otherwise profits of the corresponding years) to some of the subsequent years where there would have been profits if they were calculated without such carried down loss.

52. Thus, once the contention of the Taxpayer is upheld (which this Board does) in respect of the allowance of deduction of the sum of $156,615,001 for the year ending June 1999, the tax payable for some of the subsequent years will also have to be revised accordingly to the table annexed as Appendix hereto.

Decision

53. For the aforesaid reasons, by unanimous decision, this appeal is allowed. The provision for estimated bad debt for $156,615,001 ought to be allowed for the year ending June 1999, resulting in no profit and thus no profits tax is payable for the year 1999/2000, and with its consequential effect on the loss carried down and profits tax payable for some of the subsequent years as set out in paragraph 16 above, namely, net loss for all those years which are the subject of this appeal.

54. To conclude, this Board's decision as to the respective chargeable profit and profits tax for the years of 1999/2000, 2002/2003, 2003/2004, 2004/2005, 2005/2006, and 2006/2007, is that they are all nil. The relevant assessments of profits tax for these years under the Determination are all set aside.

55. The appeal as to the balance of the provision in 1999 which was disallowed by the Determination (that referable to the principal part), has not been pursued in this appeal. But, in any event, it has no effect on the tax payable for the relevant years which are the subject of this appeal.

56. There be no order as to costs.

Appendix

Company F (the Taxpayer)

Summary of tax position per IRD's assessments

	Year of assessment							
	1999/2000 Y.A. 30-06-1999	2000/01 Y.A. 30-06-2000	2001/02 Y.A. 30-06-2001	2002/03 Y.A. 30-06-2002	2003/04 Y.A. 30-06-2003	2004/05 Y.A. 30-06-2004	2005/06 Y.A. 30-06-2005	2006/07 Y.A. 30-06-2006
(Adjusted loss) / assessable profits per return [B1/4]	(216,797,463)	(1,393,005)	(5,555,455)	(101,168)	4,214,691	6,242,305	5,669,915	9,329,195
Add: non-deductible provision for bad debt [per IRD's assessments / determination]	220,335,000			2,741,000	4,874,000	2,090,000		
Less: written back for doubful debts [per IRD's assessments]							(207,000)	
Net chargeable profits / (tax loss) [per IRD's assessments]	3,537,537	0	0	2,639,832	9,088,691	8,332,305	5,462,915	9,329,195
Tax thereon [per IRD's assessments]	566,005 @16%	0	0	422,373 @16%	1,590,520 @17.5%	1,458,153 @17.5%	956,010 @17.5%	1,632,609 @17.5%

Summary of tax position (with deduction of provision for doubtful debt of HK$156,615,001 in 1999/2000)

	Year of assessment							
	1999/2000 Y.A. 30-06-1999	2000/01 Y.A. 30-06-2000	2001/02 Y.A. 30-06-2001	2002/03 Y.A. 30-06-2002	2003/04 Y.A. 30-06-2003	2004/05 Y.A. 30-06-2004	2005/06 Y.A. 30-06-2005	2006/07 Y.A. 30-06-2006
(Adjusted loss) / assessable profits per return [B1/4]	(216,797,463)	(1,393,005)	(5,555,455)	(101,168)	4,214,691	6,242,305	5,669,915	9,329,195
Add: non-deductible provision for bad debt [per IRD's assessments / determination]	220,335,000	1,380,000	5,543,000	2,741,000	4,874,000	2,090,000		
Less: deductible provision for bad debt	***(156,615,001)***							
Less: written back for doubful debts							(207,000)	(50,000)
Net chargeable profits / (tax loss)	(153,077,464)	(13,005)	(12,455)	2,639,832	9,088,691	8,332,305	5,462,915	9,279,195
Tax loss brought forward		(153,077,464)	(153,090,469)	(153,102,924)	(150,463,092)	(141,374,401)	(133,042,096)	(127,579,181)
Add: tax loss of the year	(153,077,464)	(13,005)	(12,455)					
Less: loss set off				2,639,832	9,088,691	8,332,305	5,462,915	9,279,195
Tax loss carried forward	(153,077,464)	(153,090,469)	(153,102,924)	(150,463,092)	(141,374,401)	(133,042,096)	(127,579,181)	(118,299,986)