

Case No. D20/18

Profits tax – appellant raising loan from bank and transferring to a related company following the Group’s treasury policy – deduction of bank charge and bank loan interest – whether bank charge and bank loan interest incurred in producing profits to which the Appellant was chargeable – whether any real necessity for Appellant to raise facility – whether Appellant illiquid – whether the loan surplus to the Appellant’s requirements – sections 16, 17 and 68 of the Inland Revenue Ordinance (Chapter 112) (‘IRO’)

Panel: Wong Kwai Huen Albert (chairman), Jen Julienne and Li Joseph Chiu Wah.

Date of hearing: 29 August 2018.

Date of decision: 4 February 2019.

The Appellant was a company incorporated in Hong Kong with principal business on property investment, development and letting and sale of completed properties. The Appellant, Companies B, C and D were related companies and members of Group E (‘Group’). The Appellant and Company D were wholly-owned subsidiaries of Company B. Company C handled the operations of, and acted as banker to, the Appellant and other members of the Group, by placing the Group’s surplus funds with Company D in order to generate interest on time deposits pending the Group’s funding requirements.

In 2014, the Appellant borrowed a 3-year loan of HK\$300 million from the bank, guaranteed by Company B and secured by a mortgage over Tower G (‘Property’), to which the Appellant was the developer. The Appellant later instructed the facility (‘Facility’) to be effected, and immediately transferred the loan to Company D’s account. In 2015, the bank debited HK\$450,000 from the Appellant’s account as set up fee for the Facility (‘Bank Charge’). The Appellant also paid interest to the bank on the Facility (‘Bank Loan Interest’). Meanwhile, Company D received interest on the HK\$300 million.

The Commissioner determined that the Bank Loan Interest and the Bank Charge (‘Deductions’) were not deductible. The Appellant objected to the Determination. In the appeal hearing before the Board, the Appellant called a director of the Appellant and Company B (‘Mr F’) to give evidence on, *inter alia*, the Group’s treasury policy. Mr F gave evidence saying that if the Appellant were to be asked to pay a dividend to its shareholder, i.e. Company B, it would not be necessary for actual cash to be returned from Company C, which would simply be instructed to credit the amount of Company B.

Held:

1. In ascertaining profits in respect of which a person was chargeable to tax, outgoings and expenses incurred in the production of profits to which he

was chargeable should be deductible. Certain types of expenses, e.g. expenditure of a capital nature, were excluded. Interest on money borrowed and expenses incurred in connection therewith would qualify for deduction where particular requirements were met if the borrowing was for the purpose of producing profits to which the taxpayer was chargeable.

2. The term ‘purpose of producing profits’ was not to be given a restricted and literal meaning. It included expenses incurred in order to maintain (rather than to produce) profits, such as: (a) payment of accrued retirement grants to striking employees which enabled the taxpayer to continue business; (b) where an asset-rich but liquidity-poor company incurred a trading liability and the creditor agreed to accept deferred payment upon terms providing for interest so that the company might avoid having to liquidate profit-earning assets; (c) where a company, having already borrowed at interest from bankers who later pressed for repayment, could only find suitable alternative funding at interest from its shareholders. To the extent that the amount borrowed was genuinely necessary for the taxpayer’s business and not surplus to requirements, interest paid on the borrowed amount would be deductible. However, if the retained earnings was surplus to requirement and the subsequent borrowing was similarly surplus to the requirement of the company, the interests paid on the borrowing would not be deductible (Zeta Estates Ltd v Commissioner of Inland Revenue [2006] 2 HKLRD 208 and [2007] 10 HKCFAR 196 and Federal Commissioner of Taxation v Roberts and Smith [1992] 23 ATR 494 considered).
3. The Board should consider all objective factors in order to determine whether the Facility was necessary. During the relevant tax years, the Appellant has maintained modest cash level and would not normally need to keep substantial amount of cash. It was difficult to comprehend a situation where Company C, whilst acting as the banker and treasurer of the Appellant and being its major debtor of about HK\$897 million, would demand a sum of HK\$300 million from the Appellant which clearly did not have the cash in hand, all in the name of the Group’s treasury policy, which was neither logical nor reasonable. It was obvious that it was Company C who decided which company within the Group should borrow at any given time. The decision did not come from the Appellant and the reason to borrow could be quite unconnected with the needs of the Appellant. In view of the substantial credit balance due from Company C, the Facility appeared to be surplus to the requirement of the Appellant. The Facility was not intended solely, nor was it applied at all, in the production of the Appellant’s profit. If the Facility had produced a profit, it was not the Appellant’s own chargeable profit.
4. Whilst it was not crucial on the part of the borrower to prove a legal necessity, there must be a purpose to be served and a genuine necessity for the borrowing in connection with the Appellant’s business, be that legal,

contractual, regulatory or commercial. The present case was not one where the Appellant raised the Facility in order to discharge any kind of liability. The Appellant was simply following the direction of Company C to do what the Group considered necessary to finance other business activities of the Group at the material time.

Appeal dismissed and costs order in the amount of \$25,000 imposed.

Cases referred to:

Federal Commissioner of Taxation v Roberts and Smith [1992] 23 ATR 494
Wharf Properties Ltd v Commissioner of Inland Revenue [1995] 1 HKLR 347
Zeta Estates Ltd v Commissioner of Inland Revenue [2006] 2 HKLRD 208 (CA)
Zeta Estates Ltd v Commissioner of Inland Revenue [2007] 10 HKCFAR 196 (CFA)
Commissioner of Inland Revenue v Swire Pacific Ltd [1979] HKLR 612
FCT v Munro [1926] 38 CLR 153

Adrian Y H Lai, Counsel, instructed by Messrs Li & Partners, for the Appellant.
John Brewer, Counsel and Clement Au, Assistant Counsel, instructed by Department of Justice, for the Commissioner of Inland Revenue.

Decision:

1. The Appeal

This is an appeal commenced by Company A ('the Appellant') against the determination of the Deputy Commissioner of Inland Revenue dated 6 March 2018 ('the Determination') and the two Additional Profits Tax Assessments raised on the Appellant for the years of assessment 2014/2015 and 2015/2016.

2. The Issue

The issue under the appeal is whether the interest and related charges incurred by the Appellant on a HK\$300 million bank loan should be allowed for deduction under Section 16 of the Inland Revenue Ordinance ('IRO').

3. The Salient Facts

3.1 The Appellant and the Respondent have agreed those facts Upon which the Determination was arrived at together with the addition of facts recorded in the Appellant's audited accounts for the years

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ended 31 March 2014, 2015 and 2016. A copy of the Agreed Statement of Facts is annexed to this decision and the Board of Review ('the Board') will adopt the abbreviations used therein.

3.2 For ease of reference, the salient facts of this appeal are stated below:

- a. The Appellant's principal activities at the material times were property investment, property development and letting and sale of its completed properties;
- b. The Appellant, Company B, Company C and Company D are related companies and members of Group E ('the Group'). The Appellant and Company D are wholly-owned subsidiaries of Company B whilst Company C is not;
- c. Company C handled the operations of, and acted as banker to, the Appellant and other members of the Group pursuant to a long-established treasury policy;
- d. Company C placed Group companies' surplus funds with Company D in order to generate interest on time deposits pending the Group's funding requirements;
- e. On 27 June 2014, the directors of the Appellant resolved to borrow HK\$300 million ('the Sum') from the Bank guaranteed by Company B and secured by a mortgage over, and assignment of rentals and insurance in respect of, the Property;
- f. On 10 September 2014, the Appellant instructed the Facility to be effected on 18 September 2014; whereupon the Bank credited the Sum to the Appellant's account. The Appellant immediately transferred the Sum from the Appellant's account to that of Company D's;
- g. On 7 January 2015, the Bank debited HK\$450,000 from the Appellant's account as set up fee for the Facility ('the Bank Charge');
- h. The Appellant paid interest on the Facility of HK\$2,530,382 for the period 18 September 2014 to 31 March 2015 and HK\$4,807,280 for the year ended 31 March 2016 ('the Bank Loan Interest');
- i. Company D received interest on the HK\$300 million of HK\$1,782,967.70 for the period 18 September 2014 to 31

March 2015 and HK\$2,448,087.84 for the year ended 31 March 2016;

- j. The Respondent had determined that the Bank Loan Interest and the Bank Charge ('the Deductions') were not deductible. The Appellant objected to the Determination.

4. The Appellant's case

4.1 The Appellant's financial position being illiquid as of 31-03-2014

- (1) Since the Facility was granted on 12 June 2014 and utilized on 10 September, 2014, it is pertinent to consider the Appellant's financial position, in particular its liquidity, prior to the grant and utilization of the Facility.
- (2) The Appellant's financial position for the year ended 31 March 2014 showed that:
 - a. The Appellant's working capital was financed principally by its accumulated profits (including accumulated revaluation gain);
 - b. Over 80% of the Appellant's assets were fixed assets;
 - c. The Appellant only held modest level of cash;
 - d. There was a balance of amount due from Company C in the sum of approximately HK\$897 million. This balance represented part of the surplus (i.e. profits available for distribution) Company C had drawn from the Appellant in exercising its banker's function pursuant to the Group's treasury policy;
 - e. Almost all of the Appellant's turnover derived from property-related business, out of which over 80% of the Appellant's turnover derived from rental business;
 - f. The Appellant only recorded a modest level of cash inflow during the year 2013/2014. The Appellant's operating cash flow was far from sufficient to finance its investing activities, which was to enhance the Appellant's income-generating capacity. Even if one were to discount the change in the amount due to Company C during the said year, the operating cash inflow was still insufficient to finance the Appellant's investment activities.

- (3) Regarding the amount due from Company C as recorded in the Appellant's books, the Appellant draws the Board's attention to the following facts:
 - a. it had been the Group's long-established treasury policy of centralizing the member companies' surplus (in the nature of profits available for distribution) into the hands of Company C, which acted as the treasurer of the Group; and
 - b. it was the Appellant's duty under the policy to pass HK\$300 million surplus (in the nature of distributable profit) to Company C upon demand.
- (4) It is to be borne in mind that according to the witness, Mr F, the reason behind the Appellant's raising the loan of HK\$300 million, was to meet its obligation under the treasury policy to transfer a part of the Appellant's profits to Company C.
- (5) Whilst the Appellant's financial position could be said to be liquid for the purpose of meeting external debts, it is simply illiquid, for the purpose of meeting Company C's demand.

4.2 *The Appellant Remained Illiquid During 2014/2015 and 2015/2016*

The Appellant's financial position for the years ended 31 March, 2015 and 31 March, 2016 remained illiquid:

- a. The Appellant's financing structure was altered. Whilst the Appellant's working capital remained largely financed by its accumulated profits (including accumulated revaluation gain), there was an increased reliance (compared to 2013/2014) on liabilities (from less than HK\$200 million to over HK\$500 million).
- b. An overwhelming part of the Appellant's working capital remained to be fixed assets;
- c. The Appellant's cash level remained modest;
- d. As already mentioned in paragraph 4.1(2)(e) above, almost all of the Appellant's turnover derived from property-related business, of which over 85% was from rental business;

- e. The Appellant's operating cash flow, having discounted the change in the amount due to Company C during the said year, remained modest. It was either barely sufficient to finance its investing activities (2015/2016) or simply insufficient to do so (2016/2017).

4.3 *The Appellant's taking out the Facility during year 2014/2015*

- (1) On 12 June, 2014, the Bank granted the Facility to the Appellant. The facility letter contained, amongst others, the following terms:

‘4. Purpose

For corporate funding needs of the Borrower [i.e. the Appellant] and [Group E].

6. Interest

6.2 The Borrower shall pay to the Lender interest ... to be the aggregate of (i) of [sic] 1.35% per annum and (ii) [the HIBOR] rate. Interest shall be calculated on the basis of the actual number of days elapsed and a year of 365 days.

10. Fees

The Borrower shall pay to the Lender a set up fee at the rate of 0.15% [i.e. HK\$450,000] flat and such fee to be payable upon acceptance of this facility letter.

12. Security

...

A first legal mortgage in the form and substance acceptable to the Lender for all monies from the Borrower over [Tower G] ... [i.e. the Appellant's own property]’

- (2) As mentioned in paragraph 3.2(f) above, the Facility was later drawn down. Upon Company C's instructions, the Sum was paid into the Appellant's bank account and immediately transferred to Company D.

4.4 *The Appellant's interest expenses and finance charge*

- (1) The Appellant incurred the Bank Charge and Bank Loan Interest as mentioned in paragraph 3.2(g) and (h) above during the years of assessment 2014/2015 and 2015/2016.
- (2) The said Bank Charge and Bank Loan Interest were duly reported by the Appellant in its tax returns for 2014/2015 and 2015/2016.

4.5 *The Respondent's inquiries and the Appellant's response*

- (1) On 24 June, 2016 the Respondent proposed to disallow the Deductions for the year of assessment 2014/2015 on the ground that the Facility had been applied to finance non-income producing assets.
- (2) On 29 August, 2016, the Appellant, through its accountants, replied to the Respondent stating, amongst other things, that the Facility had been borrowed to finance the Appellant's income generating assets. It further explained the role of Company C as the Appellant's banker.
- (3) The Appellant further explained in writing that the Sum transferred to Company D was made at the direction of Company C.
- (4) According to the Appellant, the Group's treasury policy was:

‘... [Company C], ... [Company D] and the Company are members of the “[Group E]” ... The ultimate beneficial owner of the Group is the estate of [Ms H]. The operations of the Group's companies are handled through [Company C], which also acts as the Group's banker. Any surplus funds of the Group collected by [Company C] are temporarily placed with [Company D] as time deposits for generating interest income pending for the funding requirements by the other Group's companies and the fundings for future investment strategies.’
- (5) The Appellant avers that the Respondent should have allowed the Deductions by accepting the Appellant's explanations and taken into account the Group's treasury policy.

5. The Respondent's case

- 5.1 The Respondent challenged the Appellant's case mainly on the basis of the following points:

- (a) The Facility was not applied towards the ‘purpose of producing profits’ of the Appellant during the relevant years of assessment.
- (b) The Appellant was not illiquid at the material time. As of 31 March 2014 and shortly prior to arranging the Facility, the Appellant’s cash, bank balances and the balance of the related company loan account were almost HK\$900 million; whereas total liabilities were only HK\$190 million.
- (c) There was no need for the Appellant to borrow from external sources for its own business purposes.
- (d) The Appellant’s case is predicated entirely upon the false premise of necessity, being a group treasury policy imperative to advance additional funds to Company C which could not be met unless it were to liquidate assets or resort to external sources of finance.
- (e) However, Company C’s request was entirely different in nature from the examples given in various authorities such as trading liability, damages award and refinance due to banker’s pressing for repayment or meeting the demand of controlling shareholders. The Appellant was under no legal imperative or obligation to entertain Company C’s request.
- (f) The Appellant applied the Facility to assist Company D in the production of Company D’s profits from interest on bank deposits; rather than towards producing Appellant’s own profits.
- (g) This is not a case where the Appellant borrowed in order to discharge any kind of liability (whether towards Company C, Company D or any other Group company or any third party). There is also nothing in the Appellant’s case demonstrating that the interest on the Sum was incurred for the purpose of producing profits to which the Appellant was chargeable to profit tax nor the Facility was necessary for the Appellant to maintain its existing profit-producing capacity.

6. The Witness

The Appellant called Mr F, a director of the Appellant and Company B to give evidence on, among other things, the Group’s treasury policy. The Appellant has drawn the Board’s attention to the fact that Mr F’s evidence

on the treasury policy had not been subject to serious challenge under cross-examination.

7. The Authorities

7.1 The Appellant produced the following authorities:

1. Section 16 of IRO
2. Federal Commissioner of Taxation v Roberts and Smith [1992] 23 ATR 494
3. Wharf Properties Ltd v Commissioner of Inland Revenue [1995] 1 HKLR 347
4. Zeta Estates Ltd v Commissioner of Inland Revenue [2006] 2 HKLRD 208 (CA)
5. Zeta Estates Ltd v Commissioner of Inland Revenue [2007] 10 HKCFAR 196 (CFA)

7.2 The Respondent produced the following authorities:

1. Section 17 and Section 68 of IRO
2. CIR v Swire Pacific Ltd [1979] HKLR 612
3. FCT v Munro [1926] 38 CLR 153

8. The Applicable Legal Principles

8.1 Sections 16 & 17 of IRO

- (1) Section 16(1) provides that when ascertaining profits in respect of which a person is chargeable to tax that there shall be deducted outgoings and expenses to the extent they are incurred by such person in the production of profits to which he is chargeable; Section 17(1) then excludes particular types of expenses from deduction, such as expenditure of a capital nature.
- (2) Interest on money borrowed by a taxpayer and expenses incurred in connection therewith will qualify for deduction under Section 16(1) where the particular requirements of Section 16(2) are met if the borrowing is for the purpose of producing profits to which the taxpayer is chargeable.

- (3) Other than the corollary found at Section 17(1)(b) to the basic requirement of Section 16(1), there is no suggestion that any interest and bank charge are specifically excluded on account of the remaining provisions of Section 17.
- (4) The question for the Board is whether the Deductions were incurred in producing profits to which the Appellant was chargeable and thus deductible.

8.2 *Zeta Estates Ltd v CIR*

The Court of Final Appeal has established that:

- (1) The term ‘purpose of producing profits’ found in Section 16(1)(a) included payment of accrued retirement grants to striking employees where no profits were produced as a direct result of the payment but where the payment indirectly, but plainly, enabled the taxpayer to continue business and thereby produce chargeable profits;
- (2) The term is not to be given a restricted, literal meaning. Section 16(1)(a) will be satisfied in circumstances where the purpose for which the expense is incurred in order to maintain profits, rather than directly produce profits;
- (3) Where an asset-rich but liquidity-poor company incurs a trading liability and the creditor agrees to accept deferred payment upon terms providing for interest so that the company may avoid having to liquidate profit-earning assets, the borrowing would be incurred for the purpose of maintaining profits;
- (4) The same principle applies where the company chooses to borrow from shareholders at interest in order to meet a substantial damages award;
- (5) Where a company, having already borrowed at interest from bankers who later pressed for repayment, can only find suitable alternative funding at interest from its shareholders, the borrowing would be incurred for the purpose of maintaining profits;
- (6) In the above situations, the interest expenses paid would be treated as having been incurred for the purpose of producing profits to which the taxpayer is chargeable;

- (7) To the extent that the amount borrowed was genuinely necessary for the taxpayer's business and not surplus to requirements, then interest paid on the borrowed amount would be deductible-

'... if the retained profits were required by the business of the company (that however would not prevent the declaration and payment of dividend, if the company remained in a sound financial footing afterwards), interest on shareholders' loans made to replace the retained profits would be deductible.'

- (8) The converse, however, also applies -

'... if the retained earnings in respect of which the dividend was declared was surplus to the business requirement of the company and the subsequent borrowing was similarly surplus to the requirement of the company, the interests paid on the borrowing would not be deductible.'

8.3 *Federal Commission of Taxation v Roberts*

The Court of Final Appeal in Zeta Estates referred to FCT v Roberts:

'Where borrowings at interest by a solicitors' partnership to fund repayment to partners of their capital contributions were held to have been incurred in the production of assessable income — it mattered not what private use the partners put their repayments once received because as far as the partnership taxpayer was concerned the character of the refinancing took on the same character as the original borrowing and gave to the interest incurred the character of a working expense.'

9. Our Decision

9.1 *Liquidity*

- (1) There is no definite formula to measure the liquidity of any business entity. A great deal depends on how easy the entity can obtain cash or gain access to funds. Equally, it is not easy to list out all types of liquid assets of a business entity. Cash or cash equivalents are obviously liquid assets but it is more difficult to decide whether 'the amount due from a related company' can be considered liquid asset.
- (2) The Board takes note of the modest cash level maintained by the Appellant during the relevant tax years. This is not

surprising as the evidence shows that over 80% of the Appellant's turnover derived from its rental business and all its rental income was paid directly to Company C acting as the Appellant's banker.

- (3) In fact, the evidence shows that the Appellant would not normally need to keep substantial amount of cash. Mr F testified that if the Appellant were to be asked to pay a dividend to its shareholder, i.e. Company B, it would not be necessary for the actual cash to be returned from Company C, which would simply be instructed to credit the account of Company B.
- (4) The Board also takes note that in the Appellant's books, apart from the cash level, there was a balance of approximately HK\$897 million due from Company C representing an amount of distributable profit transferred to Company C. The Appellant's case is that Company C had drawn this sum from the Appellant in exercising its banker's function pursuant to the Group's treasury policy; hence, this sum should be discounted so that whilst the Appellant's financial position could be said to be liquid for the purpose of meeting external debts, it was illiquid for the purpose of meeting Company C's demand. The Board has some difficulty in accepting this contention.
- (5) The Board finds it difficult to comprehend a situation where Company C whilst acting as the banker and treasurer of the Appellant and being its major debtor of about HK\$897 million would demand a sum of HK\$300 million from the Appellant which clearly did not have the cash in hand, all in the name of the Group's treasury policy. The Appellant contends that the Board should not challenge this long-established treasury policy, which seemed to be that whenever the Appellant had surplus cash, it should be transferred to Company C interest-free but when it needed cash including meeting cash demands made by Company C, it had to borrow from an outside bank, of course, with interest. The Board finds this policy neither logical nor reasonable.
- (6) As already mentioned, the Appellant would not normally need to maintain a high cash level unless Company C called for a cash transfer. Once such a call was made, the Appellant would have no choice but to resort to external financing. It is therefore obvious that it was Company C who decided which company within the Group should borrow at any given time. The decision did not come from the Appellant and the reason

to borrow could be quite unconnected with the needs of the Appellant.

- (7) The Appellant contends that it remained illiquid during the years 2014/2015 and 2015/2016. The Respondent made a detailed analysis on the financial position of the Appellant and the true meaning of ‘surplus’ to demonstrate that the Appellant was liquid at the material time. The Respondent also avers that at the material time both the Appellant and the Group as a whole were not short of cash at all. The Appellant takes issue with the Respondent’s understanding of assets or working capital vis-a-vis profits/surplus.
- (8) The Board considers that it is not necessary to dwell on the accounting principles of assets and liabilities. It is also irrelevant to consider the cash position of the Group. Suffice to say, on the evidence available, the Board is not convinced that there is a valid reason to discount the credit balance of the sum of HK\$897 million from the Appellant’s current assets for the purpose of deciding its liquidity. Further, there is little evidence of the Appellant’s investment activities or other funding requirements at the material time. There is simply no sufficient evidence to prove that the Appellant was illiquid during the relevant tax years.
- (9) In view of this substantial credit balance due from Company C, the Facility appeared to be surplus to the requirement of the Appellant.
- (10) The Board also agrees with the Respondent’s contention that there was no reason why the Appellant could not have mortgaged the Property to enable Company C to enter into borrowing arrangements of its own. This is not an intrusion to the domain for management decision. The Board should consider all objective factors on the circumstances in order to find whether the Appellant was liquid or illiquid and whether the Facility was necessary at the material time.

9.2 *The Facility*

- (1) The legal principles in the Zeta case and other relevant authorities are stated above. The Board is tasked with the finding as a matter of fact whether the Facility was raised for the ‘purpose of producing profit’, a term which should not be given a restricted or literal meaning in view of the principles embodied in Zeta.

- (2) The Appellant reminds the Board that in deciding the nature of the Facility, it would be unduly narrow to consider only where the money went after the Facility had been taken out. The Appellant refers to the following test given by Tang JA in Zeta (C A) in relation to interest payable on a loan taken out in order to pay a dividend:

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

- (3) The Appellant contends that Tang JA, in formulating his test, did not suggest that the ‘necessity’ should be legal necessity. Otherwise, it would distort the test and render it unworkable. The Appellant put forward the analogies of ordinary business having to consult a lawyer to ensure a borrowing meeting the legal necessity test, and a law firm with an illiquid asset portfolio would be unable to claim deduction of interest if the borrowing was for settling Counsel’s fees, which are not legally enforceable debts.
- (4) The Appellant further avers that the Respondent was inviting the Board to commit the errors made in Zeta i.e. by tracing the funds in order to determine whether Section 16(2) of the IRO has been satisfied. The Appellant referred to Lord Scott’s decision in CFA:

‘... The Board appears ... to have concentrated on the question whether “fresh working capital was needed...”... This was the wrong question. Whether fresh working capital was needed, and whether or not a dividend should be declared out of accumulated net profits, were questions for the commercial judgment of the directors. They were no possible concern of the Commissioner, or the Board of Review, or the courts. The question relevant to Zeta’s tax liability and to the

deductibility of the interest paid on the borrowings to raise the fresh working capital is why the capital was raised. If the fresh capital was raised by Zeta in order to retain, or maintain, its profit-earning assets the interest on the borrowings would, in my opinion, in principle be deductible under 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.'

- (5) The Board accepts that the term 'the purpose of producing profit' must not be given a narrow or restricted meaning and that 'maintaining a profit' is just as good as 'producing profit'. However, it should also be noted under Section 16(1) of the IRO any borrowing must be for the purpose of producing and/or maintaining profit to which the taxpayer, in this case the Appellant, is chargeable.
- (6) The Board finds that the Facility was not intended solely, nor was it applied at all, in the production of the Appellant's profit. This was stated in the Facility Letter that the Facility was for corporate funding needs of the Borrower and Group E. In Mr F's evidence, the Facility was not applied towards the Appellant's needs but rather for those of the Group's. This was supported by the fact that the Sum was transferred to Company D interest free the same day received by the Appellant. Company D earned interest on the Sum. Hence, if the Facility had produced a profit, it was not the Appellant's own chargeable profit. It should be noted that Company D was not chargeable to any tax in relation with the Sum. The Board has reminded itself of the danger of being unduly narrow in its approach in finding the purpose of the Facility. Equally, the Board should not only consider where the Sum went after the Facility had been drawn down. However, the Board should take into consideration the immediate and proximate reason for the Facility which must be for the purpose of producing Appellant's chargeable profits.
- (7) The term 'purpose of producing profits' has been held to include payment of accrued retirement grants to striking employees, settling a trading liability with creditors, meeting a substantial damages award as well as making a bank repayment. In all these instances, there was clearly a liability or an obligation on the part of the borrower to be discharged.
- (8) The Board has considered the Respondent's contention that the Group's treasury policy created no legal obligation on the

part of the Appellant towards Company C nor was the Appellant under any form of liability to Company C. The Board has come to the conclusion that whilst it is not crucial on the part of the borrower to prove a legal necessity, there must be a purpose to be served and a genuine necessity for the borrowing in connection with the Appellant's business, be that legal, contractual, regulatory or commercial. In all the examples given in Zeta, there was in existence such a necessity. In each case, it can be said that but for the borrowings, certain liability would have arisen with adverse consequences to the borrowers. This situation did not seem to exist in the Appellant's case.

- (9) The Board does not find those analogies made by the Appellant as mentioned above particularly helpful. Business people often make commercial decisions which may bear legal implications without consulting their lawyers. Although it is not a legal duty, solicitors are required to settle counsel's fees; failing to do so will give rise to professional conduct issues.
- (10) It is true that the treasury policy was not seriously challenged by the Respondent during cross-examination. It is because it was not so much a question whether such a policy did exist within the Group. But rather, whether following the Group's treasury policy was so imperative that it was tantamount to a real necessity for the Appellant's business. Alternatively, whether meeting Company C's demand for cash should be considered as a discharge of the Appellant's liability. The Board finds that it is plainly not the case. Company C, in its capacity both as the banker and the treasurer of the Group, simply made the decision which Group company should borrow at any time taking into consideration the needs of the Group as a whole rather than those of the Appellant. Hence, it is not a case where the Appellant raised the Facility in order to discharge any kind of liability as illustrated in the Zeta case. The Appellant was simply following the direction of Company C to do what the Group considered necessary to finance other business activities of the Group at the material time. This case is clearly distinguishable from the matters and principles established in Zeta.
- (11) Lastly, the Appellant has averred to the written resolutions of the directors of the Appellant passed on 8 July, 2016 resolving that an interim dividend of HK\$1,263 million was to be distributed out of the Appellant's profits to its shareholder, Company B.

- (12) Putting aside whether this resolution was an afterthought, the declaration of dividends was made two years after the Facility had been drawn down. This matter is of no relevance to the present appeal.

10. Conclusion

At all material time, the Appellant was not illiquid. There was no real necessity for the Facility to be raised by the Appellant. The Facility was not arranged for the purpose of producing profits to which the Appellant was chargeable to profit tax. Deductions should not be allowed.

11. The Appellant has not discharged its onus of proving that the two Additional Profits Tax Assessments were excessive and incorrect.

12. The appeal is dismissed. Pursuant to section 68(9) of the IRO, the Appellant is ordered to pay as costs of the Board in the sum of \$25,000.

B/R XX/XX
Company A v CIR

AGREED STATEMENT OF FACTS

- (1) Company A ('the Appellant') has objected to the Additional Profits Tax Assessments for the years of assessment 2014/15 and 2015/16 raised on it. The Appellant claims that interest and the related charge incurred on a bank loan should be allowable deductions.
- (2) (a) The Appellant is a private company incorporated in Hong Kong in 1964. The Appellant closed its accounts annually on 31 March.
- (b) For the period from 1 April 2014 to 31 March 2016 ('the Period'), the Appellant's directors were:
- Mr F
Mr J
Mr K (Resigned on 22 October 2015)
Mr L (Resigned on 14 January 2015)
- (c) In the reports of its directors for the years ended 31 March 2015 and 2016, the principal activities of the Appellant were described as property investment, property development, letting and sale of its completed properties.
- (3) (a) During the Period, the Appellant and Company D were members of Group E ('the Group') and wholly owned subsidiaries of Company B. Both Company D and Company B are private companies incorporated in Hong Kong.
- (b) The principal activity of Company D for the Period was placing time deposits at banks for interest income.
- (4) Company C is a private company incorporated in Hong Kong. During the Period, it was a related company of the Appellant and Company B that provided management and administration services to the Group.
- (5) The Appellant was the developer of Tower G ('the Property'), the occupation permit of which was issued in February 1995. The Property was one of the investment properties held by the Appellant during the Period.

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(6) By a letter dated 12 June 2014 ('the Facility Letter'), Bank M ('the Bank') agreed to provide to the Appellant a 3-year loan facility of \$300 million or 25% of the open market value of the Property, whichever was lower ('the Facility'), on, among other things, the following terms and conditions:

- (a) The purpose of the Facility was for corporate funding needs of the Appellant and the Group.
- (b) The Appellant should pay to the Bank interest on each advance for each interest period at the rate to be the aggregate of 1.35% per annum and the rate determined by the Bank to be that at which Hong Kong Dollar deposits in amounts comparable with the advance and for a period equal to and for value on the first day of such interest period were being offered to first class banks in the Hong Kong interbank market (HIBRO).
- (c) The Appellant should repay the advances in full in one lump sum on the termination date, which meant 36 months from the date of first drawdown.
- (d) The Appellant should pay to the Bank a set up fee at the rate of 0.15% flat and such fee to be payable upon acceptance of the Facility Letter.
- (e) As security for its obligations under the Facility Letter, the Appellant should execute and deliver to the Bank, among other things, a first legal mortgage over the Property.

On 27 June 2014, the Appellant and Company B, as guarantor, confirmed their acceptance of the Facility on the terms and conditions set out in the Facility Letter.

- (7)
- (a) By a drawdown notice dated 10 September 2014, the Appellant gave the Bank notice that, pursuant to the Facility Letter, it wished an advance in the amount of \$300 million ('the Sum') to be made to it on 18 September 2014.
 - (b) On 18 September 2014, the Bank credited the Sum into the Appellant's account. Then the Appellant transferred the Sum to Company D.

Copies of the credit advice and the debit advice both dated 18 September 2014 issued by the Bank to the Appellant in respect of the drawdown of the Sum and the transfer of the Sum from the Appellant to Company D are produced to this Board of Review ('the Board').

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- (8) (a) Company D placed the Sum in a time deposit account with the Bank and derived the following interest income during the periods ended 31 March 2015 and 2016:

Period	Deposit days	Interest rate	Interest income \$
18-09-2014 to 18-12-2014	91	1.1900%	890,054.79
18-12-2014 to 16-02-2015	60	1.1000%	544,075.17
16-02-2015 to 31-03-2015	44	0.9600%	348,837.74
			<u>1,782,967.70</u>
01-04-2015 to 16-04-2015	15	0.9600%	118,921.96
16-04-2015 to 16-07-2015	91	0.8400%	632,257.00
16-07-2015 to 19-10-2015	95	0.8000%	629,934.11
19-10-2015 to 19-01-2016	92	0.8000%	611,311.68
19-01-2016 to 31-03-2016	73	0.7500%	455,663.09
			<u>2,448,087.84</u>

- (b) In the tax computations of Company D for the years ended 30 June 2015 and 2016, all its interest income from bank deposits was claimed as exempted income. In its Profits Tax Return for the year of assessment 2015/16, Company D declared nil Assessable Profits.

- (9) The Appellant filed Profits Tax Returns for the years of assessment 2014/15 and 2015/16 with its audited financial statements and tax computations for the respective years ended 31 March 2015 and 2016.

- (a) In the returns, the Appellant declared the following Assessable Profits:

	<u>2014/15</u>	<u>2015/16</u>
	\$	\$
Assessable Profits	44,257,844	39,059,690
<u>After deducting:</u>		
Bank loan interest	2,530,382	4,807,280
Bank charge	450,000	-

- (b) The Appellant's statements of financial position as at 31 March 2014 to 2016 showed the following particulars:

As at 31 March	2014	2015	2016
	\$	\$	\$
Non-current assets			
Investment properties under redevelopment	960,000,000	1,053,000,000	879,000,000
Investment properties in Hong Kong	2,657,047,400	2,875,099,800	3,234,386,800

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As at 31 March	2014	2015	2016
	\$	\$	\$
Leasehold properties under development	92,064,234	96,817,034	-
Available-for-sale financial assets	389,377,845	391,304,473	393,318,113
Other non-current assets	-	1,011,260	1,195,731
	4,098,489,479	4,417,232,567	4,507,900,644
Current assets			
Amount due from Company C	897,264,349	1,243,441,672	1,263,198,603
Cash and bank balances	1,899,073	4,554,944	2,620,650
Other current assets	20,429,800	12,330,561	18,412,392
Total current assets	<u>919,593,222</u>	<u>1,260,327,177</u>	<u>1,284,231,645</u>
TOTAL ASSETS	<u>5,018,082,701</u>	<u>5,677,559,744</u>	<u>5,792,132,289</u>
Non-current liabilities			
Bank loan-secured	-	300,000,000	300,000,000
Deferred tax liabilities	14,869,144	16,369,850	18,523,287
	14,869,144	316,369,850	318,523,287
Current liabilities			
Amount due to investee partnership	145,663,789	178,643,789	199,043,789
Amount due to fellow subsidiaries	15,000	6,929	70,033
Amount due to a related company	149,777	487,965	157,150
Tenants' deposits	21,818,873	20,621,967	24,918,168
Other current liabilities	6,815,014	5,236,982	10,815,722
	<u>174,462,453</u>	<u>204,997,632</u>	<u>235,004,862</u>
TOTAL LIABILITIES	<u>189,331,597</u>	<u>521,367,482</u>	<u>553,528,149</u>
Share capital	2,000,000	2,000,000	2,000,000
Accumulated profits	<u>4,826,751,104</u>	<u>5,154,192,262</u>	<u>5,236,604,140</u>
TOTAL EQUITY	<u>4,828,751,04</u>	<u>5,156,192,262</u>	<u>5,238,604,140</u>

(c) The Appellant's statements of comprehensive income for the years ended 31 March 2014, 2015 and 2016 showed the following particulars:

For the year ended 31 March	2014	2015	2016
	HK\$	HK\$	HK\$
Revenue	92,566,452	98,220,859	101,080,745

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For the year ended 31 March	2014 HK\$	2015 HK\$	2016 HK\$
Cost of sales	<u>(203,122)</u>	-	<u>(2,281)</u>
	92,363,330	98,220,859	101,078,464
Other revenue			
Sundry income	691,935	565,080	661,545
Rates received	<u>2,723,476</u>	<u>3,204,634</u>	<u>2,896,142</u>
	<u>95,778,741</u>	<u>101,990,573</u>	<u>104,636,151</u>
Operating expenses			
Advertising and promotional expenses	522,693	500,568	548,288
Agency fees and commissions	2,634,716	1,886,660	1,024,648
Air conditioning charges	125,976	121,084	199,788
Audit fee	65,000	72,000	87,000
Bad debts written off	266,165	-	-
Building management charges	16,213,465	18,523,767	18,329,490
Cleaning charges	288,312	280,204	54,981
Depreciation	-	206,540	718,020
Insurance	37,510	92,632	120,457
Legal and professional fees	427,876	379,107	268,019
Office management fee	10,526,000	14,718,000	14,876,000
Staff costs	247,980	599,630	1,282,952
Provision for doubtful debts	113,378	11,046	34,620
Rates and government rent	4,018,765	5,033,945	5,425,319
Repairs, maintenance and tenancy works	1,898,742	2,114,683	3,131,347
Security guard service	645,581	327,434	162,746
Stamp duty	100,360	67,294	81,487
Sundry expenses	405,904	296,024	796,395
Utilities charges	<u>456,191</u>	<u>515,219</u>	<u>776,883</u>
	<u>38,994,614</u>	<u>45,745,837</u>	<u>47,918,440</u>
Profit from operations	56,784,127	56,244,736	56,717,711
Finance cost			
Interest on bank loan	-	(2,530,382)	(4,807,280)
Bank charges	-	(450,000)	-
Increase in fair value of investment properties	79,404,150	282,960,054	39,079,732
Profit before taxation	136,188,277	336,224,408	90,990,163
Taxation	<u>(9,359,371)</u>	<u>(8,783,250)</u>	<u>(8,578,285)</u>
Profit for the year	126,828,906	327,441,158	82,411,878
Other comprehensive income for the year	-	-	-
Total comprehensive income for the year	<u>126,828,906</u>	<u>327,441,158</u>	<u>82,411,878</u>

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(d) The breakdown of the Revenue of the Appellant for the years ended 31 March 2014, 2015 and 2016 is as follows:

For the year ended 31 March	2014 HK\$	2015 HK\$	2016 HK\$
Sales of properties	2,479,000	-	36,850
Rental income	77,264,890	85,355,909	88,734,157
Building management income	<u>9,356,562</u>	9,593,950	9,920,638
Advertising income	<u>3,466,000</u>	<u>3,271,000</u>	<u>2,389,100</u>
	<u>92,566,452</u>	<u>98,220,859</u>	<u>101,080,745</u>

(e) The Appellant's statements of cash flows for the years ended 31 March 2014, 2015 and 2016 showed the following particulars:

For the year ended 31 March	2014 HK\$	2015 HK\$	2016 HK\$
Cash flows from operating activities			
Profit before taxation	136,188,277	336,224,408	90,990,163
Interest income	(59)	(456)	(456)
Depreciation		206,540	718,020
Provision for bad debts	113,378	11,046	34,620
Surplus on property revaluation	(79,404,150)	(282,960,054)	(39,079,732)
Interest on bank loan and bank charges		2,980,382	4,807,280
Operating profit before working capital changes	56,897,446	56,461,866	57,469,895
Decrease in properties for sale	203,122		2,281
(Increase) decrease in debtors and prepayments	1,307,094	1,855,272	(5,957,061)
Decrease (increase) in utility and other deposits	(215,827)	(14,481)	35,428
Increase in amount due from a related company	(19,533,908)	(346,177,323)	(19,756,931)
Increase (decrease) in tenants' deposits	1,874,306	(1,196,906)	4,296,201
Increase (decrease) in creditors, advance receipts and accrued expenses	1,599,971	(1,695,384)	5,657,155
Increase (decrease) in amount due to fellow subsidiaries	15,000	(8,071)	63,104
(Decrease) increase in amount due to a related company	149,777	338,188	(330,815)
Cash generated from (absorbed by) operations	42,296,981	(290,436,839)	41,479,257
Profits tax paid	(20,127,941)	(1,035,142)	(6,621,947)
Interest received	59	456	456
Interest paid on bank loan and bank charges		(2,863,030)	(4,885,695)
Net cash from (used in) operating activities	<u>22,169,099</u>	<u>(294,334,555)</u>	<u>29,972,071</u>
Cash flows from investing activities			
Purchase of fixed assets	(182,075)	(6,106,115)	(14,875,619)
Increase in investment properties under redevelopment	(7,305,375)	(23,204,031)	(31,529,304)
Increase in leasehold properties under development	(47,613,957)	(4,752,800)	(3,887,802)
Increase in available-for-sale financial assets	(659,706)	(1,926,628)	(2,013,640)

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For the year ended 31 March	2014	2015	2016
	<u>HK\$</u>	<u>HK\$</u>	<u>HK\$</u>
Net cash used in investing activities	<u>(55,761,113)</u>	<u>(35,989,574)</u>	<u>(52,306,365)</u>
Cash flows from financing activities			
Increase in amount due to an investee partnership	35,360,000	32,980,000	20,400,000
Drawdown of bank loan	-	300,000,000	-
Net cash from financing activities	<u>35,360,000</u>	<u>332,980,000</u>	<u>20,400,000</u>
Net (decrease) increase in cash and cash equivalents	1,767,986	2,655,871	(1,934,294)
Cash and cash equivalents at beginning of the year	<u>131,087</u>	<u>1,899,073</u>	<u>4,554,944</u>
Cash and cash equivalents at end of the year	<u>1,899,073</u>	<u>4,554,944</u>	<u>2,620,650</u>
Analysis of cash and cash equivalents			
Cash and bank balances	<u>1,899,073</u>	<u>4,554,944</u>	<u>2,620,650</u>

(f) In the notes to the Appellant's financial statements for the years ended 31 March 2015 and 2016, it was disclosed, among other things, that:

- (i) The Appellant's investment properties (including those under redevelopment) were stated in the statements of financial position at fair value as determined annually by professionally qualified valuers. The increase in fair value of investment properties for the years ended 31 March 2015 and 2016 were \$282,960,054 and \$39,079,732 respectively.
- (ii) As at 31 March 2015 and 2016, the Appellant's investment property with a carrying value of \$1,388 million (i.e. the Property) was mortgaged to a bank as security for a loan of \$300 million (i.e. the Sum). The loan would be repayable on 18 September 2017.
- (iii) The amount due from Company C was unsecured, interest-free and with no fixed repayment terms.
- (iv) There was no interest income derived from related parties.

(10) In accordance with the returns, the Assessor raised on the Appellant the following Profits Tax Assessments for the years of assessment 2014/15 and 2015/16:

	<u>2014/15</u>	<u>2015/16</u>
	\$	\$
Assessable Profits	<u>44,257,844</u>	<u>39,059,690</u>
Tax Payable thereon	<u>7,282,544</u>	<u>6,424,848</u>

The Appellant did not object to the assessments.

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(11) The Assessor opined that the bank loan interest and bank charge incurred for the year of assessment 2014/15 should not be tax deductible. By a letter dated 24 June 2016, the Assessor explained her view to the Appellant’s representatives, Messrs W M Sum & Co (‘the Representatives’), proposed to disallow the bank loan interest and bank charge for that year of assessment, and requested the Appellant to furnish further information if it did not agree with the proposed adjustments.

(12) The Appellant disagreed with the Assessor’s proposal and through the Representatives provided the information:

- (a) The bank loan interest for the years of assessment 2014/15 and 2015/16 was paid to the Bank in respect of the Sum.
- (b) The bank loan interest for the year of assessment 2014/15 was analysed as follows:

Period	Interest rate	Interest \$
18-09-2014 to 19-10-2014	1.56332%	411,174.58
20-10-2014 to 19-11-2014	1.57786%	402,030.08
20-11-2014 to 21-12-2014	1.58013%	415,595.84
22-12-2014 to 21-01-2015	1.58214%	403,120.60
22-01-2015 to 22-02-2015	1.58286%	416,313.86
23-02-2015 to 22-03-2015	1.58512%	364,794.74
23-03-2015 to 31-03-2015	1.58643%	117,352.36
		2,530,382.06

- (c) The bank charge was the set up fee computed at 0.15% on the Sum, which was paid in accordance with Clause 10 of the Facility Letter.
- (d) The sole business carried on by Company D was placing time deposits at banks for interest income. Interest income derived by Company D from the Sum was exempted from payment of Profits Tax pursuant to the Exemption from Profits Tax (Interest Income) Order 1998.

(13) The Representatives provided copies the following documents:

- (a) The Group’s general ledger in respect of the Appellant’s current account with Company D as of 31 March 2015 showing the following entries:

<u>G/L Date</u>	<u>Explanation</u>	<u>Debit</u> \$	<u>Credit</u> \$
18-09-2014	Fund Trsf	XXXXXXXXXX 300,000,000	

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<u>G/L Date</u>	<u>Explanation</u>	<u>Debit</u>	<u>Credit</u>
		\$	\$
31-03-2015	C/A clearing XXXXXXXXXXXX		300,000,000

(b) Journal entries with document number of XXXXXXXXX of G/L Date 18 September 2014 recording the transfer of the Sum from the Appellant to Company D.

(c) The Group's general ledger in respect of the Appellant's current account with Company C as of 31 March 2015, which showed, among other things, the following entry:

<u>G/L Date</u>	<u>Explanation</u>	<u>Debit</u>
		\$
31-03-2015	C/A clearing XXXXXXXXXXXX	300,000,000

(d) Journal entries with document number of XXXXXXXXX of G/L Date 31 March 2015 showing, among other things, the following entries in the books of Company C:

<u>Account</u>	<u>Debit</u>	<u>Credit</u>
	\$	\$
C/A with Company D	300,000,000	
C/A with the Appellant		300,000,000

(e) Written resolutions of the directors of the Appellant passed on 8 July 2016 resolving that an interim dividend of \$1,263 million was to be distributed out of the Appellant's profits to its registered shareholder, Company B, and that the interim dividend be paid on the date of the resolutions by crediting to the account of Company B.

(14) The Representatives contended the following:

(a) The Sum was borrowed based on commercial decision of the Appellant.

(b) The Appellant's operations were handled through Company C, which also acted as the Appellant's banker. All operating receipts and expenditures were handled by Company C. That indicated that funds retained in the current account with Company C were derived from the Appellant's operations.

(c) Prior to obtaining the Sum, the Appellant's income generating assets were financed entirely by its share capital, accumulated profits, amount due to investee partnership and other operating liabilities, as indicated in its statement of financial position as at 31 March 2014.

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Management of the Group, and indeed, directors of the Appellant considered that it was desirable to have part of the Appellant's income generating assets financed by external funding and to use part of the Appellant's accumulated profits to finance business activities of the Group. The Sum was therefore taken out to replace that part of shareholder's equity and to partly finance the Property, which was pledged to secure such borrowing.

- (d) As Company C operated as the treasury company of the Group and banker of the Appellant, all surplus funds remained in the current account with Company C. The Appellant's financial position as at 31 March 2015 should be analysed as follow:

Non-current assets	4,417,232,567
Less: Accumulated revaluation surplus	<u>3,471,310,621</u>
	945,921,946
Add: Current assets	<u>16,885,505</u>
Total assets other than the amount due from Company C	962,807,451
Financed by: Share capital	2,000,000
The Sum	300,000,000
Deferred tax liabilities	16,369,850
Current liabilities	<u>204,997,632</u>
Assets financed by surplus fund	439,439,969
Less: The Surplus fund	<u>1,682,881,641</u>
Amount due from Company C	<u><u>1,243,441,672</u></u>

(Representing surplus funds placed with Company C)

The Sum was thus obtained to partly finance the Appellant's income generating assets to replace the financing previously provided by the Appellant's accumulated profits. Interest thereon should therefore be deductible.

- (e) Company C, Company D and the Appellant were members of the Group. The ultimate beneficial owner of the Group was the estate of the late Ms H. The operations of the Group's companies were handled through Company C, which also acted as the Group's banker. Any surplus funds of the Group collected by Company C were temporary placed with Company D as time deposits for generating interest income pending funding requirements by other members of the Group and funding for future investment strategies.
- (f) The bank loan interest and the bank charge were deductible for the following reasons:

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- (i) The interest-free loan to Company C was advanced out of part of the Appellant's surplus funds derived from operations.
- (ii) The Sum was borrowed for financing the Appellant's income generating assets (i.e. completed investment properties).
- (g) In Zeta Estates Ltd v CIR (2007) 10 HKCFAR 196, the Court of Final Appeal held that the Appellant was entitled to pay dividends and replace shareholders' finance with interest-bearing loans. The interest incurred on such interest-bearing loans was deductible. On 8 July 2016, the Appellant paid an interim dividend of \$1,263 million.
- (h) The book entries of the interim dividend paid were as follow:

<u>Date</u>	<u>Account</u>	<u>Debit</u> \$	<u>Credit</u> \$
08-07-2016	Interim dividend paid C/A with Company B	1,263,000,000	1,263,000,000
08-07-2016	C/A with Company B C/A with Company C	1,263,000,000	1,263,000,000

(15) The Assessor was of the view that the bank loan interest and the bank charge were not deductible. She raised on the Appellant the following Additional Profits Tax Assessments for the years of assessment 2014/15 and 2015/16:

	<u>2014/15</u>	<u>2015/16</u>
	\$	\$
Bank loan interest [Fact (9)(a)]	2,530,382	4,807,280
Bank charge [Fact (9)(a)]	<u>450,000</u>	
Additional Assessable Profits	<u>2,980,382</u>	<u>4,807,280</u>
Tax Payable thereon	<u>491,763</u>	<u>793,202</u>

(16) The Appellant through the Representatives objected to the above assessments claiming that the Sum was used to finance the Appellant's assets which generated chargeable profits to the Appellant and that the bank loan interest and the bank charge incurred thereon should be tax deductible.

(17) The Representatives further contended the following:

- (a) 'it is common commercial practice in private unlisted groups that excess funds are placed with the group's treasury company on a regular/daily basis for obvious commercial reasons. Dividends are "paid" on a yearly or a longer period basis by crediting shareholders' accounts as described [in *Fact (14)(h)*]'

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- (b) ‘... the decision as to how the assets of the Appellant are to be financed is a commercial decision of the Appellant. This principle is clearly set out in [Zeta]. The Appellant had investment properties in excess of \$2,650 million in 2014 and produced rental income of \$85.3 million. The investment properties together with its other assets were principally financed by the Appellant’s accumulated profits of \$4,826 million, without resorting to external financing. In 2015, the Appellant considered that it was desirable to alter its means of financing in making use of external financing available and took up a small portion of external funding by means of a \$300 million bank loan [i.e. the Sum] which only accounted for less than 6% of its after tax accumulated profits. The funds thus generated, as with other funds generated from its operation, were placed with [Company N]. How [Company N] made use of its funds is not the Appellant’s business and should not affect the Appellant’s tax position.
- (c) With due respect, we think that undue emphasis has been placed on the physical flow of funds. As pointed out in [Zeta], the emphasis should be on the financial position of the Appellant, which clearly indicates that [*the Sum*] taken out was to supplement the Appellant’s accumulated profits to finance its income generating assets. Interest expense arising therefrom should be deductible under Section 16(1)(a) of the Inland Revenue Ordinance [(“IRO”).’