Case No. D10/94

Profits tax – onus of proof – claim by taxpayer that it had incurred interest payments.

Panel: William Turnbull (chairman), Felix Chow Fu Kee and Vincent Liang Wan Sang.

Date of hearing: 3 March 1994.
Date of decision: 10 May 1994

The taxpayer was a private limited company carrying on a trading business in Hong Kong. It exported products to Europe. Because of quota restrictions the taxpayer used the services of an overseas company. The taxpayer claimed to have incurred payments of interest which should be allowed as deductions from its profits. The assessor disallowed the interest payments. The taxpayer claimed that it had incorrectly entered the interest payments in its accounts.

Held:

The onus of proof is on the taxpayer. The taxpayer had a history of incorrectly handling interest payments and tax thereon. This placed a clear burden of proof on the taxpayer to justify its claim that in the year of assessment in question it had made a mistake in its accounts. The taxpayer had failed to satisfy the burden of proof.

Appeal dismissed.

Cases referred to:

D35/86, IRBRD, vol 2, 259
Chinachem Investment Co Ltd v CIR 2 HKTC 261

Iris Ng Yuk Chun for the Commissioner of Inland Revenue.
Taxpayer represented by its accountant.

Decision:

This is an appeal by a limited company against an assessment wherein the Taxpayer has been assessed to interest tax on certain sums of money which the

Commissioner claims were interest payments made by the Taxpayer to a third party outside Hong Kong. The facts are as follows:

1. The Taxpayer had for many years been carrying on a trading business of Product A. The trading business included the export of Product A to European markets.

2. Because of quota restrictions of Product A, an associated company of the Taxpayer was incorporated in Country A. The modus operandi of the Taxpayer and its associate in Country A was for Product A to be exported to Europe in the name of the company in Country A. The goods would be sourced by the Taxpayer and sold by the Taxpayer to the company in Country A. The company in Country A would then on sell the goods to the ultimate customer in Europe. Payment for the goods would be made to the company in Country A and the company in Country A would account to the Taxpayer for the proceeds of sale.

3. To enable the foregoing business to be transacted a bank account with a bank in Hong Kong ('the bank') was opened in the name of the company in Country A. The company in Country A did not have any banking facilities with this bank and it relied upon the Taxpayer for any finance which it required. The bank account was to enable it to handle the receipt of the proceeds of sale of the goods which it sold to Europe and to account for the same to the Taxpayer. Bills drawn by the company in Country A on its customers could be negotiated through its bank account in Hong Kong.

4. Since as early as the year of assessment 1981/82 the Taxpayer had shown in its accounts certain interest payments made to other companies. The Inland Revenue Department requested particulars of these interest payments from the Taxpayer in respect of the year of assessment 1981/82. In default of receiving any information from the Taxpayer the assessor issued an estimated assessment upon the Taxpayer assessing the Taxpayer to interest tax which the Taxpayer should have deducted at source when making payment of the interest in question. The Taxpayer accepted and paid this estimated assessment.

5. Similar situations arose in respect of the years of assessment 1982/83, 1983/84 and 1984/85. In each of these years interest tax estimated assessments were raised on the Taxpayer in respect of interest which it had paid during the year in question and which interest payments had been revealed in its audited accounts when the same were filed with the Inland Revenue Department together with the profits tax returns for the Taxpayer.

6. In respect of the year of assessment 1985/86 no interest payments were shown in the audited accounts of the Taxpayer and accordingly no interest tax assessment was raised on the Taxpayer for that year.

7. In respect of the year of assessment 1986/87 the Commissioner sent to the Taxpayer an interest tax return form for completion. By letter dated 23 November 1987 the Taxpayer wrote to the Inland Revenue Department and stated that no interest had been paid during the year of assessment in question and accordingly the interest tax return form could not be completed.

8. A profits tax return form had been sent to the Taxpayer in respect of the year of assessment 1986/87 by the Commissioner in the usual way. This should have been returned by the Taxpayer within one month and extensions of time could have been granted to the Taxpayer if requested up to about October or November 1987. The Taxpayer did not file this tax return on time and the same was filed on 6 September 1989 together with the audited accounts of the Taxpayer. The audited accounts of the Taxpayer showed that the Taxpayer had paid interest during that year of assessment to three companies, one being $326,000 to the associated company in Country A. The other two interest payments are not material to this appeal. In accordance with previous practice the assessor raised an estimated assessment dated 16 January 1990 upon the Taxpayer in respect of the interest payment of $326,000 which had been shown in the audited accounts of the Taxpayer.

9. By letter dated 9 February 1990 the Taxpayer wrote to the Inland Revenue Department and stated that: 'the interest paid to the associated company in Country A is for settlement of bank interest due to (the Bank). Therefore no interest tax is payable for the year.'

10. On 12 March 1990 the assessor wrote to the Taxpayer making enquiries regarding the interest payment $326,000. By letter dated 24 May 1990 the Taxpayer replied as follows:

> '(The Taxpayer) buying goods from Country B and exporting through (its associate in Country A) to some of the overseas buyers. Bills usually drawn at D/P or D/A basis. (The Bank) will purchase the bills and credit the proceeds to (the Country A associate's) account. The proceeds will then transfer back to (the Taxpayer's) account. Once the buyer has settled the bills, the overdue interest and charges will be debited to (the Country A associate's) account in overdraft status. (The Taxpayer) are responsible to cover the overdue and overdraft interest.
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> (The Taxpayer) has its own properties pledged to the bank for obtaining the facilities.'

11. On 10 August 1990 the assessor wrote again to the Taxpayer making further enquiries with regard to the interest payment of $326,000. The Taxpayer replied by letter dated 5 November 1990 as follows:

> 'We have to ask the bank to send us all the bank statement for the relevant period. But now we can only present the statement of November 1984 for your reference. The overdraft balance was settled in year of assessment 1986/87. (The associate in Country A) is a company incorporated in Country A.'

12. The copy bank statement sent to the Inland Revenue Department showed that on 14 May 1986 a sum of $317,550.40 was debited by the Bank to the current account of the associate in Country A, and that on 15 May 1986 a deposit was made into that account of

$326,000. Prior to those two entries the associate in Country A had a small overdraft of $7,919.81 and immediately following the two transactions just set out the account of the associate in Country A showed a small balance of $529.79.

13. By letter dated 17 August 1993 the Taxpayer submitted to the Commissioner copies of a number of bank documents and, referring to the enclosed documents, stated: 'The nature of transaction was shown clearly that only $3,471.47 was interest and the balance $314,078.93 was payment for settlement of bills outstanding. The Audit A/C shown in the year of assessment 1986/87 was wrongly posted.'

14. By his determination dated 20 September 1993 the Deputy Commissioner decided against the Taxpayer and confirmed the interest tax assessment against which the Taxpayer has objected.

15. By letter dated 29 September 1993 the Taxpayer gave notice of appeal to the Board of Review against the determination of the Commissioner on the ground that 'a major part of the "loan interest" in dispute was in fact payment for settlement of bills outstanding'.

16. The Taxpayer was operating its business at a loss and in respect of the year of assessment 1986/87 it incurred a substantial loss which was greatly in excess of the amount of the interest in respect of which it was assessed to interest tax.

At the hearing of the appeal the Taxpayer was represented by its accountant and a director. Both the accountant and the director chose to give evidence and were cross examined. The director explained to the Board how the Taxpayer operated its business and its relationship with the associate in Country A. He said that the Taxpayer had never paid any interest to the associate in Country A and that the amount paid by the Taxpayer to the associate in Country A represented the price of the goods which had been shipped to Europe. The accountant when giving evidence said that the goods had been rejected by the customer in Europe. This caused the bank to debit the account of the associate in Country A with the amount of the bills which had previously been paid by the Bank. As the associate in Country A had no overdraft facilities it was necessary for the Taxpayer to make payment into the account of the associate in Country A to cover the amount debited by the Bank. The accountant said that a mistake had been made in the accounts of the Taxpayer and that this payment had been incorrectly shown as interest. The accounts had then been audited and filed with the Inland Revenue Department when the Taxpayer filed its profits tax return. He said that the Taxpayer did not know about the mistake until they heard from the Inland Revenue Department. However the witness was not entirely clear as to the exact date when the Taxpayer thought it had made a mistake.

Other than the copy banking documents which the Taxpayer had obtained from the bank no accounts, journal entries, ledger accounts or vouchers were produced before the Board.

The representative for the Commissioner referred us to the facts, pointed out that the onus of proof is upon the Taxpayer and submitted that the Taxpayer had not

discharged the onus of proof. In support of her submission she cited to us D35/86, IRBRD, vol 2, 259 and Chinachem Investment Co Ltd v CIR 2 HKTC 261.

The question which we have to decide in this case is simple. Was the payment of $326,000 made by the Taxpayer to its associate in Country A interest?

The onus of proof is placed upon the Taxpayer by section 68 of the Inland Revenue Ordinance. In many cases the onus of proof is quite light and it is comparatively easy in an appropriate case for the Taxpayer to discharge its burden of proof. However that is not the case before us.

The facts of the case before us are straight forward. The Taxpayer is the author of its own destiny and of its own misfortune, if indeed there be any misfortune.

The Taxpayer over the years has consistently ignored its interest tax obligations. It has chosen to pay the full amount of interest to companies where it should have deducted interest tax at source. It apparently failed to do so. Instead it chose to reveal interest payments in its audited accounts when the same were submitted to the Inland Revenue Department together with its profits tax returns. This caused the assessor to issue estimated interest tax assessments which the Taxpayer regularly paid. The Taxpayer appears to have ignored its interest tax obligations even though after the year of assessment 1981/82 it must have known about those obligations.

In respect of the year of assessment 1986/87, the Taxpayer did not file its profits tax return until September 1989, some two years late. In its audited accounts for that year the Taxpayer disclosed interest payments to three companies one of which was the sum of $326,000 now in dispute.

Based on its audited accounts that the company had paid $326,000 interest to its associate in Country A. The assessor, in accordance with past practice, issued an estimated interest tax assessment on the Taxpayer. The Taxpayer did not then come forward any say it had made a mistake but on the contrary by letter dated 9 February 1990 informed the Inland Revenue Department that 'the interest paid to (the associate in Country A) is for settlement of bank interest due to (the Bank)'. It is quite clear that at that moment in time the Taxpayer believed that an interest payment had been made. This is reinforced by the Taxpayer's letter of 24 May 1990 which again refers to payment of interest. It was not until the letter of 17 August 1993 that the Taxpayer put forward the argument that the nature of the payment was not interest, and that an accounting error had been made.

The submission and evidence made and given on behalf of the Taxpayer raises more questions than it answers. If we were to assume that an error had been made in the accounts of the Taxpayer and that the payment of $326,000 was not an interest payment we would be raising a huge question as to what it really was. In his closing submission on behalf of the Taxpayer the accountant tried to explain the mistake and what accounting entries should have been made. The Board asked for clarification with regard to the accounting system of the Taxpayer and the accountant explained that it was a hand written

system which was kept up to date. As the Board had been told in evidence that the goods to which this transaction related had been rejected by the buyer in Europe the Board enquired as to what had happened to the goods and how the transaction had been shown in the accounts of the Taxpayer. The accountant representing the Taxpayer said that he could not remember and said the goods might have been sent to a European country but he did not know. With the assistance of the director of the Taxpayer it was suggested that the goods might not have been rejected but were accepted by the customer who did not make payment for the same.

If we were to accept the claim now being made by the Taxpayer that this payment was of a different nature from that as stated in its audited accounts we would be left with the question as to how the transaction was handled in the books of the Taxpayer at the time when it arose. Whilst in 1993, or indeed even in 1990 it may not be possible for the witnesses to speak with precision from their memories, we have no doubt that at the relevant time this transaction, whatever it may have been, would have been correctly entered into the accounts of the Taxpayer. If it was rejected goods then it would have been so entered into the Taxpayer's accounts. If it was a bad debt it would have likewise been recorded. Apparently it was shown as interest paid to the associate in Country A.

The accounts of the Taxpayer were audited and were approved by its board of directors. Though mistakes can be made it must be assumed that audited accounts are true and correct unless there is clear and precise evidence to the contrary. In the case before us we have no such clear and concise evidence. We have no more than ex-post facto rationalisation by the Taxpayer that this payment was not what it was originally stated to be, namely interest. The Taxpayer has failed to put forward a convincing case that a mistake was made. The onus of proof is on the Taxpayer and the Taxpayer has failed to discharge this onus.

Accordingly this appeal is dismissed and the interest tax assessment against which the Taxpayer has appealed is confirmed.