

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D12/88

Profits tax – interest expenses incurred for acquisition and redevelopment of rental premises – whether capital – whether deductible – s 17(1)(c) of the Inland Revenue Ordinance.

Profits tax – deductions – expenses incurred by company director – whether company could claim a deduction for those expenses – s 16(1) of the Inland Revenue Ordinance.

Panel: Henry Litton QC (chairman), Glen C Docherty and Tse Tak-yin.

Dates of hearing: 12 and 13 May 1988.

Date of decision: 27 May 1988.

The taxpayer company owned restaurant premises for rental. In 1979, it acquired the adjoining site and redeveloped it, incorporating it with the restaurant premises. The taxpayer claimed a deduction for interest costs incurred in acquiring and redeveloping the adjoining site.

A director of the taxpayer had allegedly borrowed funds from a bank at interest, and had on-lent those funds to the company interest-free. The company claimed a deduction for the interest paid by the director.

Held:

- (a) The interest costs were of a capital nature and therefore not deductible.
- (b) In any case, the taxpayer was not entitled to deduct interest expenses incurred by its director, because the expenses were incurred by the director only.

Appeal dismissed.

Pauline Fan for the Commissioner of Inland Revenue.

Ho Tit-man of T M Ho & Co for the taxpayer.

Decision:

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1. There is only one point in this appeal: namely, to what extent the taxpayer company (the company) is entitled, in the ascertainment of its assessable profits, to deduct interest expenses incurred.

2. The relevant provisions in the Inland Revenue Ordinance are sub-sections (c) and (d) of section 17(1) which read as follows:

‘ 17(1) For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of ...

(c) any expenditure of a capital nature ...

(d) the cost of any improvements.’

It is the Commissioner’s case that the deductions by way of interest payments which the company has claimed for the year of assessment 1979/80 are the financial costs of expenditures of a capital nature and have been incurred in the course of improvements, and are accordingly not deductible by reason of sections 17(1)(c) and (d).

History

3. The undisputed facts are these:

- (i) On 20 April 1970 the company acquired Property A from which the company derived rental income for a number of years. During the year ending 31 March 1977 the company started to re-develop Property A. Re-development was completed in 1978 and the occupation permit for Property A was issued in May 1978.
- (ii) Property A, a four-storied structure, was built specifically for restaurant purposes.
- (iii) Within about a month of the issuance of the occupation permit for Property A, the company acquired the building next door, Property B.
- (iv) In about 1979 the company demolished the old building (Property B) with a view to re-development and incorporating the new structure into the building at Property A, thus enlarging the restaurant premises.
- (v) The building works at Property B took some time to complete and the occupation permit for Property B was not issued until May 1985.
- (vi) The company’s accounts for the year ending 31 March 1980 showed interest expenses incurred of \$974,251.

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- (vii) The interest expenses relating to Property A were capitalised in the course of development.
- (viii) In its proposed tax computation for the year of assessment 1979/80, the company at first claimed as deductible expenses the full amount of the interest payments. However, in its notice of objection dated 11 November 1985, objecting to the assessor's assessment, the company's representative confined the company's claimed deduction of interest to two items of expenditure: \$1,183,902 being the cost of land of Property B and \$33,711 being the compensation paid to the tenants of Property B.
- (ix) In the resulting computation, the company (through its representative) conceded that interest payments which could not be claimed as deductions amounted to the sum of \$317,338. In the assessor's computation, the non-allowable interest amounted to the sum of \$452,418. Thus, the matter in dispute revolved around the difference between these two figures: namely, \$135,080.

4. The notice of appeal dated 18 March 1987, to the Clerk to the Board of Review, raised only one point of appeal, and it is in the following terms:

‘We hereby give you notice of appeal against the above determination on the ground that an interest expense of \$135,080 was wrongly disallowed.’

It seems perfectly clear, therefore, that up to the stage when the appeal before the Board was lodged, the company was conceding that the interest referable to the construction costs of the development (the cost of development amounting to \$213,386) could not lawfully be charged against the assessable profits.

The hearing

5. At the hearing before us, the company was represented by Mr T M Ho.

Mr Ho, without making any application to amend his grounds of appeal, argued that the financial costs relating to the development of Property B should be allowed as a deduction in its entirety.

6. The owners of the share capital in the company are Mr X and his wife. Mr X gave evidence before us to the effect that Property A was intended to be re-developed as a restaurant. When the re-development of Property A was completed and the occupation permit issued (in May 1978), the company let out Property A to a succession of companies for use as restaurants. There was, at first, the C Restaurant, operated by C Company, and this was followed by D Restaurant operated by D Company and then E Restaurant operated by E Company. All of these restaurants were unsuccessful because the premises at Property A were too small. Mr X said that the incorporation of Property B into Property A was to

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make the restaurant premises larger, more efficient and therefore more profitable for use as a restaurant.

7. Mr X also gave evidence to the effect that part of the land cost for Property B was financed by a personal loan of \$600,000 which he obtained from a bank and which he, in turn, lent to the company interest-free. The interest charge on this sum was borne personally by Mr X and not by the company.

8. A scrutiny of the company's accounts shows that at all material times there were considerable movements in Mr X's current account with the company and that, as at 31 March 1980, the company owed nothing on the director's current account. On the other hand, the company owed a total of \$6,729,270 by way of loans and overdrafts to various banks. Accordingly, the suggestion made in evidence that Mr X had, somehow, personally financed the purchase of the land (Property B) to the tune of \$600,000 appears to us to be misconceived. In any case, we do not see the relevance of the contention. If the company incurred no liability for interest on the \$600,000 (the liability being personally assumed by Mr X), we cannot see how the company can claim any deduction for interest attributable to the \$600,000. Moreover, this has not been made a specific ground of appeal, and the evidence concerning the \$600,000 adduced through the mouth of Mr X appears to us to be a total irrelevance in this appeal.

Conclusion

9. Accepting the testimony given by Mr X as summarized in paragraph 6 above, we do not see how his evidence assists in advancing the company's case on this appeal. In our judgment, the appeal is wholly misconceived, and entirely without merit.

10. There is not the least doubt in our minds that from beginning to end Property B was a capital asset of the company. Upon its first acquisition, it yielded a rental income for the company. After its re-development was completed (in 1985), it was incorporated into the restaurant premises, and leased by the company to another concern called F Company trading as F Restaurant. The position as it stands today is that Properties A and B are leased by the company to G Company which runs the G Restaurant on the premises.

11. Mr T M Ho, in his submissions before us, said that the expenditure (in the purchase and re-development of Property B) was 'to assist in improving an existing asset, without which expenditure the existing asset would not have produced the main source of income'. He therefore argued that the financial cost of that expenditure, by way of interest, should be allowed as a deduction under section 16.

12. We simply do not understand the basis of Mr Ho's submissions. Nor do we see how the company's appeal is advanced by such a submission.

13. It seems to us plain that the expenditure on the land cost and development cost of Property B is capital in nature. Section (40)(1)(a) expressly provides that in the computation of depreciation etc 'capital expenditure' includes interest paid in respect of a

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loan made for the sole purpose of financing the provision of an industrial building or structure or commercial building or structure. We cannot see how section 17 can be construed differently.

14. This appeal is wholly without merit and must be dismissed.