Case No. D153/98

Profits Tax – licensed moneylender under Moneylenders Ordinance, Chapter 163 – loans made to associated company – whether money lent in the course of the business of the lending of money within Hong Kong – whether loans considered capital investment – bad debts – whether allowable deductions – section 16(d) and 17(1)(c) of the Inland Revenue Ordinance ('IRO'), Chapter 112.

Panel: Geoffrey Ma Tao Li SC (chairman), Erwin A Hardy and Stephen Lau Man Lung.

Dates of hearing: 5 and 6 January 1998.
Date of decision: 25 January 1999.

The taxpayer, a licensed moneylender, was a company owned and controlled by the family of Mr C. Mr C also owned 70% of the shares of Company A. Company A was run by Mr D. Between 1990-1992 the taxpayer lent approximately $29,000,000 to Company A. At the end of this period, although some repayments had been made, there was an outstanding debt of approximately $15,000,000.

The taxpayer was forced to institute legal proceedings against Company A so as to recover this balance. Although default judgement was entered against Company A, there were no payments forthcoming since Company A was, by that time, insolvent.

As a result of the partial repayments made to the taxpayer, in the year of assessment 1991/92 the taxpayer suffered an adjusted loss of $4,813,667 which it so claimed in its return for that year. In the year of assessment 1992/93, the taxpayer showed profits of $9,723,096 which took into account the bad debts incurred due to Company A.

The Commissioner rejected both provisions for bad debts. He stated that the monies were not lent in the ordinary course of the taxpayer's money lending business. Hence, they did not constitute allowable deductions under section 16(d) of the IRO. He found that, on his calculations, the taxpayer owed profits tax in excess of $3,000,000.

The Commissioner identified 3 issues for the Board to decide:

(a) Whether the taxpayer was carrying on a money lending business;

(b) Whether the sums lent by the taxpayer to Company A was money lent in the ordinary course of the lending of money; and

(c) Whether the said loss of $15,000,000 was capital in nature for the purposes of section 17(1)(c) of the IRO.

The Commissioner also presented numerous authorities form which the following principles were extracted by the Board:-

(1) There has to be a bad debt arising from money lent by the taxpayer;

(2) The taxpayer must have lent the money as a moneylender, which business the taxpayer was carrying out;

(3) The question whether a person was a moneylender had to be looked at objectively;

(4) Also, the question whether a person carries on business as a moneylender is a question of fact;

(5) Once (3) and (4) were established, the relevant loan had to be looked at to see whether it can be said to have been made in the course of the business of moneylending;

(6) For loans made to associated companies, the same test would apply although more scrutiny would be carried out to ensure that the transaction was at arm's length;

(7) It was important to look at the substance of the loan to see whether it was a proper loan or capital investment.

HELD by the Board, after having considered the evidence, observed the demeanour of Mr D and having applied the above principles to the present case:

(1) Each of the 3 issues (above) be looked at separately: Wharf Properties Limited v CIR [1994] 1 HKRC 90-073;

(2) It was clear that a bad debt had arisen from the advances made by the taxpayer;

(3) The bad debt arose from money lent by the taxpayer in the course of the business of moneylending;

(4) Even though the loans were made to an associated company of the taxpayer, there was no bar to such loans existing and when looked at objectively they represented genuine loans made in the course of the business of moneylending;

(5) The business of moneylending was carried out by the taxpayer.

(6) There was little offered by the Commissioner to substantiate the allegation that the loans were effectively capital investments.

Appeal allowed.

Cases referred to:

Wharf Properties Limited v CIR [1994] 1 HKRC 90
D44/87, IRBRD, vol 2, 438
D38/89, IRBRD, vol 4, 433
D67/91, IRBRD, vol 7, 227
D55/95, IRBRD, vol 11, 10
Litchfield v Dreyfus [1996] 1 KB 584
Newton v Pyke (1908) 24 TLR 128
Edgelow v MacElwee [1918] 1 KB 205
Official Assignee of the Property of Koh Hor Khoon v EK Liong Hin Limited [1960] AC 178
Chow Yoong Hong v Choong Fah Rubber Manufactory [1962] 209
Premor Limited v Shaw Brothers [1964] 1 WLR 978
Talcott Factors Limited v G Seifert Pty Limited [1964] NSWR 1205
Shun Lee Investment Limited v CIR [1976] HKLR 712
Harvester Stock Investment Co v Kwan Siu May [1987] 1 HKC 271

Chiu Kwok Kit for the Commissioner of Inland Revenue.
Kenneth Chow instructed by Messrs Robert Wang & Co for the taxpayer.

Decision:

Introduction

1. The Taxpayer, appeals in these proceedings against a written determination by the Commissioner of Inland Revenue dated 16 December 1996.

2. At all material times the Taxpayer was a licensed moneylender under the Moneylenders Ordinance, Chapter 163. It had been so licensed since 1984. We have seen the Taxpayer's audited accounts for the years ending 31 December 1990, 1991 and 1992. They describe the Taxpayer's business as being property leasing and money lending.

3. This appeal concerns the loans made by the Taxpayer to a company called Company A from 1990 to 1992.

4. Company A was a limited company from Country B, incorporated on 8 May 1990. 70% of the shares of this company was owned by Mr C. He was also a director. Mr

C was also a director and shareholder of the Taxpayer. It is fair to describe the Taxpayer as a company owned and controlled by the family of Mr C.

5. Company A represented a joint venture between Mr C and one Mr D. Its business involved the manufacture of garments in Country B for export. Although he was the 70% shareholder, Mr C played very little part in Company A's business and was rarely in Country B. On a day to day basis, Company A was run by Mr D, his wife and another associate.

6. There is no dispute that the Taxpayer lent substantial amounts of money to Company A over the period from January 1990 to June 1992. The amount of such advances was in excess of $29,000,000. Although repayments were made during this time, the balance outstanding totalled about $15,000,000. It is convenient to set out the exact figures:

(a) 1990

Amount lent: $10,105,817.98

Amount repaid: $9,468,411.51

(b) 1991

Amount lent: $17,394,556.20

Amount repaid: $2,108,390.24

(c) 1992

Amount lent: $1,617,032.69

Amount repaid: $2,606,653.95

7. The inability of Company A to make full repayment to the Taxpayer was brought about essentially by the failure of Company A's business.

8. Eventually, despite demands, the Taxpayer had to resort to litigation against Company A. By a writ dated 25 March 1992, the Taxpayer claimed against Company A for the sum of $14,933,951.17 together with interest. Default judgement was entered against Company A on 17 July 1992. This went unsatisfied as Company A was insolvent. Eventually, the Taxpayer made arrangements for the disposal of machinery which belonged to Company A in order to set off against the indebtedness. This has been reflected as part of the 'repayment' made in 1992: see the previous paragraph.

The issues

9. Quite clearly, the Taxpayer incurred a substantial loss as a result of the loans made to Company A and the latter's failure to repay. When the Taxpayer filed its tax return for the year of assessment 1991/92, it claimed an adjusted loss for the year amounting to $4,813,667. This arose directly as a result of provisions made in respect of the bad debt from Company A.

10. For the year of assessment 1992/93, the Taxpayer filed a tax return showing assessable profits of $9,723,096. This figure took into account losses carried over from the previous year connected to the bad debt from Company A. Again, a bad debt provision was made in this regard.

11. The Commissioner rejected the provision for bad debts in these returns. He was of the view that the provisions for bad debts in relation to the outstanding balance due from Company A to the Taxpayer were not allowable as the monies lent by the Taxpayer to Company A 'were not lent in the ordinary course of the [Taxpayer's] money lending business'. The Commissioner regarded these bad debts as not constituting allowable deductions under section 16(d) of the Inland Revenue Ordinance (the IRO), Chapter 112.

12. Revised assessable profits were therefore made and it is these revised assessments which were eventually made that are the subject matter of this appeal. The Commissioner assessed as follows:

(a) For the year of assessment 1991/92: assessable profits of $10,007,248 with tax payable of $1,651,195.

(b) For the year of assessable 1992/93: assessable profits of $10,017,674 with tax payable of $1,753,092.

13. Section 16(1)(d) of the IRO elaborates on the outgoings and expenses which may be deducted from profits in order to arrive at the assessable profits for the relevant year. It refers to:

> ' (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:
>
> Provide 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: (*Amended 7 of 1986 s 12*)

(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 IRO be treated as part of the profits of the trade, business or profession for that basis period;'

14. The Commissioner's position is that all the necessary conditions in section 16(1)(d) have been fulfilled except that the monies lent by the Taxpayer to Company A were not 'money lent in the ordinary course of the business of the lending of money within Hong Kong'. This is the issue which faces the Board in this appeal.

15. In his skeleton argument, the Commissioner has identified 3 issues for the Board to decide; they are essentially as follows:

(a) Whether the Taxpayer was carrying on a money lending transaction;

(b) Whether the sums lent by the Taxpayer to Company A was money lent in the ordinary course of the lending of money; and

(c) Whether the said loss of $14,933,951 was capital in nature for the purposes of section 17(1)(c) of the IRO.

16. These 3 questions are of course linked but we will deal with them separately. Indeed, as far as sections 16 and 17 of the IRO are concerned, it is perhaps right that they should be dealt with separately: see Wharf Properties Limited v CIR [1994] 1 HKRC 90-073. We first deal with the applicable legal principles.

Law

17. We have been referred to numerous authorities: Board of Review Decisions in D44/87, D38/89, D67/91, D55/95; Litchfield v Dreyfus [1906] 1 KB 584: Newton v Pyke (1908) 24 TLR 128; Edgelow v MacElwee [1918] 1 KB 205; Official Assignee of the Property of Koh Hor Khoon v Ek Liong Hin Limited [1960] AC 178; Chow Yoong Hong v Choong Fah Rubber Manufactory [1962] 209; Premor Limited v Shaw Brothers [1964] 1 WLR 978; Talcott Factors Limited v G Seifert Pty Limited [1964] NSWR 1205; Shun Lee Investment Limited v CIR [1976] HKLR 712; Harvester Stock Investment Co v Kwan Siu May [1987] 1 HKC 271.

18. The effect of the authorities can be summarised as follows as far as section 16(1)(d) is concerned:

(a) There has to be a bad debt arising from money lent by the taxpayer in the first place.

(b) The bad debt must arise from money lent by the taxpayer to another in the course of the business of moneylending in Hong Kong carried out by the taxpayer. There are 2 parts to this test which have to be fulfilled: first, the money must be lent in the course of the business of moneylending in Hong Kong; secondly, that business must have been carried out by the taxpayer. Both requirements must be fulfilled and in relation to the very transaction under scrutiny as well. For example, if a bad debt arises from a loan that is not made in the course of the business of moneylending (but say for private purposes), then section 16(1)(d) will be inapplicable even though the taxpayer does otherwise carry on business as a moneylender.

(c) On the first requirement, it is important to note that the business of moneylending is to be looked at objectively. In other words, one examines what was done to see whether it was, objectively, in the course of a moneylending transaction. Whether or not the taxpayer himself regarded it as in the course of his business of moneylending is not the test. Although it must always be recongnised that there will inevitably be different methods of carrying out the business of moneylending (for example the degree of risk that a moneylender takes), there are some common features that would exist. Here, we refer to matters such as a clear agreement as to the terms of loans made, interest, the repayment of both principal and interest and whether security was required. There are bound to be others.

(d) As to the requirement that the taxpayer must actually carry on the business as a moneylender, this is again a question of fact. In general terms, a person carries on such a business if he is ready and willing to lend to all and sundry. Merely lending to friends or acquaintances is insufficient. Even an occasional loan to a stranger may be insufficient. A person must be in the business of moneylending and this connotes some system, repetition and continuity.

(e) Once the business of moneylending is established and it is also established that the taxpayer carries on that business, the inquiry is then whether the relevant loan can be said to be made in the course of the business of moneylending. It will be so if it is made in order to promote that business rather than for some collateral purpose.

(f) Special care needs to be taken when one is considering loans made by the taxpayer to associated companies. However, of course, it is the same test that is applied. It is just that in the case of loans made to associated companies, it is important to be sure that the transaction is in substance an arm's length one.

19. As far as section 17(1)(d) is concerned, it may often be a fine line as to whether loans are in substance made in the course of a moneylending business or whether they represent capital investments. Here, it is important to look into the substance of transactions and to look critically at matters such as repayments of interest and principal, and the frequency of such payments.

Was there a bad debt arising from money lent by the Taxpayer to Company A?

20. There is really no dispute as to this. As stated above, bad debts have arisen from the advances made by the Taxpayer to Company A.

Did the bad debt arise from money lent by the Taxpayer in the course of the business of moneylending?

21. In our view, Yes.

22. The following matters are, we believe, important in the present case:

(a) There is no set formulae that one can apply in order to determine in every case whether a loan is made in the course of the business of moneylending. This is notwithstanding that the test is objective. Each case must be decided on the facts, although we accept that certain matters (such as interest, repayments) need special attention.

(b) Although there was no written agreement between the parties, we have seen a draft agreement (headed 'MEMORANDUM') singed by the Taxpayer. The explanation provided to us (which we accept) was that Mr D of Company A refused to sign this. The only significance here is that the Taxpayer was prepared to go through the usual formalities of a loan by having a loan agreement. This document also appears to have reflected the agreement made orally between the Taxpayer and Company A (through Mr D).

(c) It is to be noted that the loan to Company A was also approved and discussed at a meeting of the Taxpayer's board of directors held on 5 January 1990. Reference is made in the minutes of that meeting to a 'loan facility' being provided to Company A, the purposes for which the loan was to be made, the limit of the loan ($20,000,000) and the interest that was payable ('subject to fluctuation at our discretion'). There was also reference to the condition that the loan was repayable on demand. It is clear that there is some inconsistency between what is stated in the minutes and what is contained in the said memorandum, but this is not a matter of great significance. We accept the Taxpayer's evidence that the transaction was intended to be a loan.

(d) Other documents exist suggesting that the transaction was a loan. Written demands for repayment were made and when these were not complied with, proceedings were instituted. The statement of claim attached to the writ makes a specific reference to a loan having been made.

(e) It is notable that the Commissioner has not really sought to impugn the integrity of the documents nor has it been suggested that the whole arrangement was a sham, designed to hide the fact that this transaction was not a loan at all but some from of investment (direct or indirect) made by the Taxpayer in Company A.

(f) Although there appears to have been much flexibility in terms of repayment by Company A, nevertheless quite substantial repayments were made over the course of 1990 to 1992 (particularly in 1990 when sums totalling $9,468,411.51 were made). The evidence appears to establish that repayments were made when Company A itself received funds arising from the sale of the manufactured garments. This points to the rather flexible arrangements as to repayment. Although there is much to be said for the Commissioner's argument that the haphazard way in which these repayments were made is highly suggestive of the whole arrangement not being that of a loan made in the course of a moneylending business, we take the view that in the context of the present case, this way merely a case of flexibility. It is not surprising for a moneylender to be somewhat flexible in its arrangements compared with, say, a bank. We might add that even in the case of banks there is often a substantial degree of flexibility as well.

(g) The Commissioner takes the point (again a reasonable one) that looking at the whole transaction realistically, this was a case in which the Taxpayer was lending to an associated company. That may be so but as we have stated earlier, the applicable law is the same. There is no bar in our view to a moneylender making loans to an associated company nor, we should add, is it particularly suprising when a certain degree of flexibility is shown.

(h) Of course, if there is any element of a sham, this will alter the picture. We find no such element here. While it is true that the Taxpayer made loans to associated companies, there are also recorded loans made to independent persons. This by itself is not decisive but it does mean that the Taxpayer was carrying on business as a moneylender. The Commissioner makes the point that the Taxpayer did not advertise its moneylending activities. It is difficult to see exactly what point is being made here. There is no requirement that a moneylender needs to advertise and it is perhaps not surprising that the Taxpayer chose not to do this since its evidence was that the company's practice was not to lend

to strangers but only to those persons that it knew or with whom it had a close relationship. We have also seen a number of signed loan agreements and board resolutions, quite clearly evidencing loans. Again, there is no suggestion that there are somehow sham documents.

(i) The Taxpayer had very substantial lines of credit with banks. We were shown banking facility agreements made with two banks. We have also seen references in the Taxpayer's audited accounts to facilities provided by another two banks. It is true that on quite a number of occasions, monies from other associated companies were channelled into the Taxpayer and at least on one occasion, it appears that monies were provided to Company A by the Taxpayer through a payment made by one of the Taxpayer's associated companies. All this, the Commissioner argues, shows that the whole transaction was not genuinely a loan. Seen by itself, the Commissioner may have a point but in the overall context of what we have regarded as a genuine loan arrangement, this was yet another example of the flexibility in the arrangement.

23. We should observe here that we were impressed with the testimony given by Mr E. He gave what we believe to be honest testimony, not shirking from providing account of the facts, whether in his favour or not.

24. We have taken fully into account the fact that this is a case in which associated companies are involved. As we have said earlier, there is no bar to genuine loan transactions existing between associated companies. In the circumstances of the present case and in the light of the explanations provided to us, we are of the view that, objectively looked at, the loans made by the Taxpayer to Company A represented genuine loans made in the course of the business of moneylending.

Was the business of moneylending carried out by the Taxpayer?

25. In view of the findings made and the matters referred to above, quite clearly the answer is Yes. We only wish to add that the fact that only a small proportion of the Taxpayer's related to moneylending, does not mean that that business was not carried on.

Section 17(1)(c)

26. There has been some suggestion that effectively the loans were capital investments made by the Taxpayer in Company A. We reject this:

(a) The joint venture in Company A was between Mr C and Mr D. There is no suggestion that Mr C's 70% share was somehow attributable to the Taxpayer.

(b) As we have already observed, substantial repayments were made by Company A to the Taxpayer. It has not been suggested that these were somehow dividend distributions to shareholders.

(c) We have already held that the advances made by the Taxpayer to Company A represented genuine loans.

Conclusion

37. By reason of the matters aforesaid, we allow the appeal. There appear to be no consequential matters that need to be dealt with. If there are, there will be liberty to the parties to make appropriate representations.