

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D22/88

Profits tax – deductions– interest on borrowings – borrowings mixed with shareholders' funds and used to produce both assessable and non-assessable profits – whether interest expenses should be apportioned – purpose of borrowings – s 16(1)(a) of the Inland Revenue Ordinance.

Panel: Robert Wei QC (chairman), Michael Choy Wah Ying and E J V Hutt.

Date of hearing: 25 April 1988.

Date of decision: 11 July 1988.

The taxpayer was a finance company. Its funds consisted of both borrowed funds, on which it paid interest, and shareholders' funds, on which it paid no interest. These funds were mixed together in one account.

In the course of its business, the taxpayer made HK\$ loans to local customers which produced assessable profits ('taxable investments'). It also deposited funds in foreign currency accounts off-shore and invested in associated companies: these produced non-assessable profits ('exempt investments').

The taxpayer claimed a deduction for all of its interest expenses. The IRD apportioned the interest expenses in proportion to the taxpayer's taxable investments and exempt investments, and allowed a deduction only for the proportion attributable to the former.

The taxpayer claimed that its sole purpose in borrowing funds was to make taxable investments, and that its exempt investments were financed exclusively by shareholders' funds.

The Board of Review found as a fact that it was always the taxpayer's policy to use borrowed funds exclusively to make taxable investments, and to use shareholders' funds exclusively to make exempt investments (notwithstanding that the taxpayer did not keep the borrowed funds and shareholders' funds in separate accounts). The taxpayer's reason for doing this was that the rate of return which it received from exempt investments was less than the interest which it paid on its borrowings, so that it had adopted a policy to use only shareholders' funds (on which it did not pay interest) for such investments.

Held:

INLAND REVENUE BOARD OF REVIEW DECISIONS

The taxpayer was entitled to deduct all of its interest expenses.

- (a) To determine whether interest is deductible under section 16(1)(a), the decisive question is whether the taxpayer's purpose in borrowing the funds was to produce assessable profits. Evidence of the actual use to which the funds were put is relevant only for the purpose of ascertaining such purpose.
- (b) On the facts, the taxpayer's intention in borrowing the funds was to use them exclusively to produce assessable profits. This was clear despite the lack of evidence as to the use to which those funds were put.

Appeal allowed.

Case referred to:

Income Tax Case No 1133 (1969) 31 SATC 204

S P Barns for the Commissioner of Inland Revenue.

David Cheng of Hodgson Impey Cheng for the taxpayer.

Decision:

1. This is an appeal against the profits tax assessments raised on the Taxpayer, a finance company, for the years of assessment 1982/83 and 1983/84.
2. The Taxpayer contends that all its interest expenses were incurred in the production of chargeable profits, being sums payable by way of interest upon money borrowed for the purpose of making such chargeable profits; therefore that they were deductible under section 16(1)(a) of the Inland Revenue Ordinance; and that the Commissioner was wrong in disallowing a portion of these expenses. Alternatively, it says that the formula adopted by the Commissioner for the apportionment of such expenses under Rule 2A of the Inland Revenue Rules is not appropriate.
3. The facts stated in paragraph 1 of the determination of the Commissioner are agreed.
4. Mr X, a director of the Taxpayer in charge of its day to day operations, gave evidence on its behalf. No other witness was called. We find Mr X to be a credible witness. Having considered his testimony and the documents produced as well as the agreed facts, we find as set out below.
5. The Taxpayer was incorporated in Hong Kong as a private company in August 1975. It belongs to a group of companies controlled by Mr Y. It has at all material times

INLAND REVENUE BOARD OF REVIEW DECISIONS

carried on the business of lending money in Hong Kong dollars to local customers. Since 1979/80 it has also invested in off-shore foreign currency deposits, and since 1981/82 also in associated companies. At all material times the Hong Kong dollar was weak compared with the United States dollar as well as some other foreign currencies. Furthermore, at all material times, the interest rates demanded by local borrowings were higher than those offered by off-shore deposits. In these circumstances it was always the policy of the Taxpayer to fund its local lendings with borrowed money and shareholders' funds but, so far as possible, with borrowed money. In fact, it borrowed money for one purpose only, that is, that of relending it in Hong Kong at higher rates of interest. On the other hand, it was always the policy of the Taxpayer to invest its surplus shareholders' funds in off-shore deposits and later also in associated companies. To implement these policies, the Taxpayer relied on its daily reports and end of the month management reports to inform itself of the respective availability of its shareholders' funds and borrowed funds before making an appropriate investment. The Taxpayer was not able to produce these reports for our examination. However, we find that these reports existed and that the Taxpayer was able to obtain the information it required from them.

6. The Taxpayer banked with a number of banks in Hong Kong but did not maintain separate accounts for shareholders' funds and borrowed money, because it never occurred to the Taxpayer that this should be done. The system was that only one account was maintained for all the operations of the Taxpayer with each banker. Although in some instances there was also a savings account, that was not for the purpose of keeping shareholders' funds and borrowed money separate, but only to maximise interest income. Thus, all the Taxpayer's funds, whatever their sources, were put in one common pool on which the Taxpayer would draw from time to time, whatever the purpose of the drawing. For these reasons, the Taxpayer was unable to identify any of its funds with any specific use or investment.

7. The Taxpayer's case is that pursuant to its policy it borrowed money only for the purpose of lending it out to its customers and that therefore the interest expenses in question were wholly incurred in the production of the chargeable profits, that is, the interest income from local lendings. It therefore argued that rule 2A does not apply.

8. On the other hand, Mr Barns for the Revenue contends that, since it did not keep the borrowed money separate from its shareholders' funds, the Taxpayer cannot relate the borrowed money to the local lendings and therefore cannot demonstrate that the interest expenses were wholly incurred in the production of the chargeable profits. He compares the situation to a cupful of water being poured into the ocean: the cupful of water ceases to have an independent existence or identity and simply merges with the whole.

9. Section 16(1) allows deduction of expenses incurred in the production of chargeable profits including, under paragraph (a), sums payable by way of interest on money borrowed for the purpose of producing such profits. In our view, the key words are 'money borrowed for the purpose of producing such profits' and the decisive question is what was the purpose of the borrowings. If the Taxpayer intended, whenever it borrowed money, to

INLAND REVENUE BOARD OF REVIEW DECISIONS

relend it to its customers at higher rates of interest, as we have found to be the case, then the money is money borrowed for the purpose of producing the chargeable profits within the meaning of section 16(1)(a) and interest incurred thereon is deductible in computing the chargeable profits. In our view this is so even though the Taxpayer is unable to identify its lendings with any of its borrowings.

10. In this connection, we find what has been said in Income Tax Case No 1133 (1969) 31 SATC 204 to be particularly pertinent: 'It appears to me, however, that the essential relevance of the destination of money borrowed is in making a determination of purpose. Where, for instance, the actual use to which the money is put is known, one may infer from this what the purpose of the borrowing was. The known destination may further be used to test direct evidence of purpose. But where one has, as in this case, acceptable evidence in respect of the continued purpose of the borrowing and no evidence at all of the ultimate use of the money involved, it seems to me that the proved purpose must be regarded as decisive.' That case was governed by section 13(2)(a) of the Income Tax Act 1954 which allowed the deduction of 'expenditure and losses (not being expenditure and losses of a capital nature) wholly and exclusively incurred by the taxpayer during the year of assessment for the purposes of his trade or in the production of the income.' The wording is somewhat different from our section 16(1)(a), but that does not in our view affect the applicability of the dictum quoted above. During the course of its business, the appellant in Income Tax Case No 1133 received money for reinvestment from two sources: (a) interest-bearing loans from outside creditors and (b) interest-free loans from its directors and its associated company. The appellant at all times intended, when borrowing from outside creditors, to relend to others at higher rates of interest. It also invested in shares, but the sums so invested did not exceed the sum of the interest-free loans and the unappropriated profits which were available to it. All moneys received by the appellant, from whatever source, were placed in one banking account to form a common fund. Unappropriated profits were also retained in this account. The appellant was unable to identify sums borrowed with any specific investment. For income tax purposes the appellant claimed to deduct the whole of the interest paid by it on loans received by it from the interest received by it from the loans made by it as being expenditure incurred by it in the earning of that interest. The Commissioner of Taxes took the point that the ultimate use of the moneys was a decisive factor and that, as the appellant was unable specifically to identify any sums borrowed with sums invested, it was unable to discharge the onus of establishing that the whole of the interest expended by it was in the production of income. The court rejected this argument for the reasons set out in the passage quoted above.

11. In the present case, the Taxpayer showed cogent reasons for its policy of borrowing money for the only purpose of relending at higher rates of interest and of investing shareholders' funds in off-shore deposits. The year-end figures from the Taxpayer's accounts relating to issued and fully-paid share capital, retained earnings, bank overdraft and loans and other current liabilities, loans receivable, book value in Hong Kong dollars of off-shore deposits and investment in associated companies appear to be consistent with its intention to carry out that policy. We find the evidence as to purpose acceptable notwithstanding the lack of evidence of ultimate use.

INLAND REVENUE BOARD OF REVIEW DECISIONS

12. In our view the portion of the interest expenses disallowed should be deducted under section 16(1)(a). This appeal therefore succeeds and the case is hereby remitted to the Commissioner for the assessments in question to be revised.