

Case No. D25/07

Profits tax – whether interest payments to bank deductible as expenditure – sections 16(1), 17(1) of the Inland Revenue Ordinance ('IRO') – whether apportionment was appropriate – rule 2A of the Inland Revenue Rules.

Panel: Benjamin Yu SC (chairman), Ho Kai Cheong and Man Mo Leung.

Dates of hearing: 21 July and 7 September 2006.

Date of decision: 24 September 2007.

For the year of assessment in question, the taxpayer made payments to Bank B under three separate accounts. In respect of one of these accounts (the 'Account'), the taxpayer gave evidence that the payments made were interest payments under a mortgage loan extended by Bank B to the taxpayer. The loan was secured by a mortgage over Property F, which was held by Company G. Company G was owned by a Mr C and his family. Mr C was a director and manager of the taxpayer. The taxpayer gave evidence that Property F was partly used for storage of documents and also used from time to time by the taxpayer to provide accommodation to customers of the taxpayer. The taxpayer adduced no evidence as to the payments made into the other two accounts.

The issue is the deductibility of the sums paid into the three accounts.

Held:

1. Interest incurred as expenditure by the taxpayer is deductible only if such interest was incurred in the production of assessable profits: sections 16(1) and 17(1) of the IRO.
2. In cases where expenses were only partly incurred in the production of assessable profits, apportionment of such expenditure may be called for, such that only that portion of the expenditure which was incurred for the production of assessable profits should be deductible: see rule 2A of the Inland Revenue Rules.
3. The Board is prepared to accept the taxpayer's evidence that Property F was indeed used for the benefit of the taxpayer in the manner deposed to and that the

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payment of loan interest by the taxpayer would be treated as rent paid by the taxpayer to Company G for the use of Property F.

4. However, the arrangement has a significant element of subsidy by the taxpayer in favour of Company G. The interest paid would appear to have significantly exceeded the rent which would have been chargeable on an arms-length basis. In the circumstances, the payment of interest into the Account was made partially in the production of assessable profits. The case calls for an apportionment. It would be fair to allow a deduction of a sum representing the monthly market rent and allow an additional sum for management fees and rates.
5. In relation to the other two accounts, the appeal is dismissed.

Appeal allowed.

Case referred to:

D66/88, IRBRD, vol 4, 85

Liu Kwong Seng of Messrs K S Liu & Company CPA for the taxpayer.
Lai Wing Man for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This is an appeal by Company A ('the taxpayer') against the determination by the Deputy Commissioner of Inland Revenue dated 31 October 2005.
2. The appeal relates to the profits tax assessment on the taxpayer for the year of assessment 1999/2000. The issue is the deductibility of a sum of \$616,884 incurred by the taxpayer during that year of assessment.
3. Information from the tax representative of the taxpayer shows that the sum of \$616,883.95 was paid to the Bank B under three separate accounts:

	Account no	Amount
(i)	XX-XXXXXX	78,487.18
(ii)	XX-XXXXXX	34,771.71

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(iii) XX-XXXXXX 503,625.06

4. At the hearing of the appeal, the focus was on the interest payment in item (iii) above. The taxpayer adduced no evidence as to the purposes of incurring interest under the other two accounts.

The Facts

5. We find the following facts proved. They are in any event not controversial.

6. The taxpayer was incorporated in Hong Kong on 17 January 1989 under a different name. It carries on the business of trading in printing ink products. At all material times, Mr C is a director and manager of the taxpayer. The major shareholders of the taxpayer are a number of native Chinese resident in Country D. Mr C was employed as the manager in charge of the business in Hong Kong, and has also been given some shares in the taxpayer company.

7. The taxpayer enjoyed banking facilities from Bank B in respect of its trading. Facilities included an overdraft, letters of credit (L/C), trust receipts (T/R) and instalment loan. The bank loan interest of \$616,883.95 comprised interest paid in respect of facilities granted by the Bank B secured by the property of the taxpayer or property in the name of a third party.

8. Loan account no XX-XXXXXX (item (iii)) was secured by a mortgage in favour of the Bank B on a property at Address E (Property F). The Property F was a property held by a company called Company G.

Evidence

9. Mr C gave evidence before the Board. He explained that the shareholders of the taxpayer had placed their trust in the management of the business of the taxpayer upon him. He said that after the Asian financial crisis, he had asked the shareholders for an increase in capital, but was told to seek help from Bank B. The bank's attitude at the time was that it could consider increasing its facility to the taxpayer if the taxpayer could put up a property as security. Mr C said that he and his family were at the time interested in buying a property. He discussed the matter with the shareholders and it was agreed that the taxpayer would assist Mr C's company in acquiring the property by obtaining a loan from the bank, but that the property would be put up as security to obtain additional securities for the taxpayer's business activities.

10. The property which was purchased was the Property F, and it was purchased in the name of Company G, a company held by Mr C and his family. Mr C drew our attention to two letters from the Bank B, one dated 5 August 1993 and the other dated 20 May 1998. He pointed out that the limit of L/C and T/R facilities in the August 1993 letter was stated to be \$2,600,000 whereas the limit of the same facilities under the May 1998 letter was \$5,700,000.

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11. Mr C gave evidence that the Property F was partly used for storage of documents and also used from time to time by the taxpayer to provide accommodation to customers of the taxpayer. In return, the taxpayer paid the interest on the mortgage loan with Bank B. In support of that evidence, the taxpayer produced various letters from its customers confirming that representatives of the customers had been provided with accommodation in the Property F. During the adjournment between the two hearings before this Board, the taxpayer produced further proof from its customers. Also produced by the taxpayer were transfer vouchers which recorded the taxpayer's payments of the loan interest as rent. The interest paid varied each month, ranging between \$40,672.11 to \$44,928.82.

12. The Commissioner adduced in evidence a memorandum from the Commissioner of Rating and Valuation expressing the opinion that the market rent of Property F commencing from 1 January 1999 for a term of one year on an unfurnished basis was \$20,000 per month, exclusive of rates and management charges.

The Law

13. The law on which the issue in this appeal falls to be determined is clear and is not in dispute. The burden rests on the taxpayer to satisfy this Board that the assessment appealed against is incorrect or excessive: section 68(4) of the Inland Revenue Ordinance ('IRO'). Interest incurred as expenditure by the taxpayer is deductible only if such interest was incurred in the production of assessable profits: sections 16(1) and 17(1) of the IRO.

14. In cases where expenses were only partly incurred in the production of assessable profits, apportionment of such expenditure may be called for, such that only that portion of the expenditure which was incurred for the production of assessable profits should be deductible: see rule 2A of the Inland Revenue Rules; D66/88, IRBRD, vol 4, 85.

Findings

15. One member of this Board entertains serious doubt whether the mortgage of the Property F to Bank B did the fact bring about the increase in the banking facilities made available to the taxpayer. It is noted that the letter of 20 May 1998 from Bank B recorded both the 'present limit(s)' and 'revised limit(s)' of L/C and T/R to be \$5,700,000. This rather militates against the suggestion that this limit had been increased by reason of the mortgage of the Property F to the Bank B. Notwithstanding such doubt, this Board is prepared to accept the evidence of Mr C that the Property F was indeed used during the relevant year of assessment for the benefit of the taxpayer in the manner he deposed to in his evidence. The Board finds that evidence to be well supported by the written evidence obtained from the taxpayer's customers. The Board also considers the transfer vouchers produced by the taxpayer to be cogent evidence of the arrangement entered into between the taxpayer on the one hand and Mr C and his company on the other,

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namely, that the payment of loan interest by the taxpayer would be treated as rent paid by the taxpayer for the use of the Property F.

16. The Board, however, takes the view that the arrangement has a significant element of subsidy by the taxpayer in favour of Company G. The interest paid would appear to have significantly exceeded the rent which would have been chargeable on an arms-length basis. As noted above, the evidence from the Commissioner suggests that the market rent for the Property F let on an unfurnished basis would have been around \$20,000 per month.

17. In the circumstances, the Board finds that the payment of interest in account no XX-XXXXXX (item (iii)) was made partially in the production of assessable profits. In our view, this case calls for an apportionment. We have not been provided with any evidence as to whether the taxpayer paid for the furnishing of the Property F. In the absence of any such evidence, we take the view that it would be fair to allow a deduction of \$21,500 per month, by taking the market rent as \$20,000 per month and allowing an additional \$1,500 for management fees and rates.

18. As for the interest incurred by the taxpayer in the other two accounts, namely XX-XXXXXX (item (i)) and XX-XXXXXX (item (ii)), the Board noted at the hearing that the taxpayer failed to adduce any evidence that such interest was incurred for the production of assessable profits; and in the circumstances, is bound to dismiss the appeal in respect of the interest incurred in respect of those accounts.

Order

19. The Board therefore orders that this appeal be allowed and remit the assessment to the Commissioner with the opinion of the Board thereon in accordance with section 68(8) of the IRO.