INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D30/93

Profits tax – deduction of interest – whether interest had been incurred and was payable within the meaning of section 16(1) of the Inland Revenue Ordinance and was deductible under section 16(2)(c) of the Inland Revenue Ordinance.

Panel: T J Gregory (chairman), Vincent Lo Wing Sang and David Wu Chung Shing.

Dates of hearing: 19, 20 and 21 April 1993.
Date of decision: 26 October 1993.

The taxpayer claimed to be able to deduct against its assessable profits certain interest which it claimed had been incurred and was payable within the meaning of section 16(1) of the Inland Revenue Ordinance and which the assessor had refused to allow to be deducted under section 16(2)(c) of the Inland Revenue Ordinance. The taxpayer was engaged in the business of property investment for rental income. To finance the purchase of a building in Hong Kong the taxpayer borrowed most of the purchase price from a consortium of banks and its ultimate parent company and another subsidiary of the parent company both of which companies were incorporated overseas. Subsequently the parent company acquired the entirety of the loan outstanding from the taxpayer. Under the agreement between the taxpayer and its parent company interest was accrued on the loan from the parent company but was not paid. The taxpayer submitted that the interest was an allowable deduction and sought to distinguish the case of CIR v County Shipping Co Ltd 3 HKTC 267. The Commissioner submitted that the County Shipping case applied and that the interest was not deductible because it was not incurred within the meaning of section 16(1) of the Inland Revenue Ordinance and was likewise not payable.

Held:

On the facts before it the Board was satisfied that the interest was incurred in that it was a sum which there was an obligation to pay, that is, it was an undischarged accrued liability. The interest was payable. The sums in question were chargeable to tax under section 28(1) of the Inland Revenue Ordinance and accordingly qualified for deduction so far as the taxpayer was concerned. For the reasons given the Board allowed the appeal and overrule the determination of the Commissioner.

Appeal allowed in part.

Cases referred to:

CIR v County Shipping Company Limited 3 HKTC 267

Lo & Lo v CIR 2 HKTC 34
Federal Commissioner of Taxation v Commonwealth Aluminium Corporation 77 ATC 4 151
Odeon Associated Theatres Limited v Jones [1972] All ER 681
W Nevill and Company Limited v Federal Commissioner of Taxation 56 CLR 290
Emu Bay Railway Company Limited v Federal Commissioner of Taxation 71 CLR 596
Nilsen Development Laboratories Pty Limited v Federal Commissioner of Taxation 11 ATR 505
Willingale v International Commercial Bank Limited 52 TC 242
Ravc Insurance Pty Limited v Federal Commissioner of Taxation 74 ATC 4 169
Alliance Holdings Limited v Federal Commissioner of Taxation 81 ATC 4 637
Federal Commissioner of Taxation v Australian Guarantee Corporation Limited 84 ATC 4 642

Peter Davies for the Commissioner of Inland Revenue.
Peter Ickeringill of Bateson Harris in Association with Mallesons Stephen Jaques for the taxpayer.

Decision:

1. THE SUBJECT MATTER OF THE APPEAL

1.1 The Taxpayer appealed against the determination of the Commissioner dated 24 November 1992 (the 'determination') in which he:

1.1.1 Increased the profits tax assessment for the year of assessment 1987/88 dated 13 September 1989, showing net assessable profits of $2,714,390 with tax payable thereon of $488,590, to net assessable profits of $3,041,947 with tax payable thereon of $457,550.

1.1.2 Confirmed the profits tax assessment for the year of assessment 1988/89 dated 13 September 1989, showing net assessable profits of $688,252 with tax payable thereon of $117,002.

1.1.3 Increased the additional profits tax assessment for the year of assessment 1988/89 dated 26 November 1990, showing additional net assessable profits of $11,370,496 with additional tax payable thereon of $1,932,948, to additional net assessable profits of $11,415,809 with additional tax payable thereon of $1,940,687.

1.1.4 Increased the additional profits tax assessment for the year of assessment 1989/90 dated 26 November 1990, showing additional net assessable profits of $6,436,317 with additional tax payable thereon of $1,061,992, to additional net assessable profits of $6,470,045 with additional tax payable thereon of $1,067,557.

1.2 The Taxpayer's objection is that the assessments are excessive in that certain interest in each of the relevant years of assessment had not been allowed as a deductible expense. The issue between the Taxpayer and the Revenue was whether the claimed deductions in respect of interest had been 'incurred' and was 'payable' within the meaning of section 16(1) of the Ordinance and, thereafter, whether they were deductible under section 16(2)(c). Accordingly, the matters for the Board to decide are exclusively the interpretation of legislation and the obligations of the Taxpayer under the agreements referred to in paragraph 4.7 below.

2. PRELIMINARY ISSUE

Before the commencement of the appeal the Chairman advised the representatives of the parties that although he had read the papers when originally received it was only that evening that his attention had focused on the address of the Taxpayer at the time the agreements referred to in section 5 below were entered into and the signature of the attestation clause of the subordinated loan agreement, refer paragraph 5.5.1 below. The address were the offices of the Taxpayer's solicitors to which the chairman was a consultant and the witness to the subordination agreement was at that time a partner of that firm. He advised the representatives that he had not been privy to the documentation but offer the representatives the choice of proceeding or adjourning pending the appointment of another chairman. Neither representatives took objection to the appeal continuing under his chairmanship.

3. SUBSEQUENT ISSUE

On the day following the conclusion of the hearing the representative of the Taxpayer lodged with the Clerk to the Board a supplemental bundle of papers, including a supplement to his reply to the submission of the representative of the Revenue, which were circulated to members of the Board. There has to be finality to a hearing and as the representative had closed his reply to that of the representative of the Revenue the Board has decided that it should not consider this supplemental submission and its associated documents.

4. THE FACTS

The material facts, none of which were in dispute, are summarised in this section. As the appeal relates exclusively to an interpretation of the Inland Revenue Ordinance (the 'Ordinance'), the subordinated loan agreement, refer section 4.7.1 below,

and the shareholders subordination agreement, refer section 4.7.2 below, the detail of the Taxpayer's tax return, the initial assessments, the correspondence between the Revenue and the Taxpayer and the assessments referred to in paragraph 1.1 above are not referred to exhaustively.

4.1 It was not in dispute that the facts set out in section 1 of the determination were correctly stated.

4.2 The Taxpayer was incorporated under the Companies Ordinance as a private limited company in 1985. The Taxpayer changed the name under which it was incorporated to its present name during May 1987.

4.3 At all relevant times the Taxpayer was engaged in the business of 'property investment for rental income'.

4.4 To finance the purchase of a building in Hong Kong (the 'property') the Taxpayer borrowed the greater proportion of the purchase price from:

4.4.1 a consortium of banks (the 'banks'); and

4.4.2 its ultimate parent company (the 'parent company') and another subsidiary of the parent company, both of which companies were incorporated overseas and contributed equally to this part of the Taxpayer's borrowing.

4.5 At a date unknown to the Board the parent company acquired the interest of the other subsidiary and the parties to the appeal were content that the appeal proceeded on the basis that the parent company had been the sole lender of the loan and solely entitled to receive all the interest thereon.

4.6 From the documents produced to the Board, refer paragraph 4.7 below, the borrowing from the banks was regulated by a loan agreement dated 4 February 1987, a copy of which was not produced at this appeal.

4.7 On the same day, 4 February 1987, two additional agreements were entered into:

4.7.1 An agreement entitled (and hereinafter referred to as the 'subordinated loan agreement') between the parent company and the Taxpayer. This agreement recited, first, the agreement of the banks to advance the loan referred to in paragraph 4.4.1 above, and, secondly, the agreement of the parent company to make loans to the Taxpayer to finance the acquisition of the property. The terms of this agreement relevant to this appeal provided:

4.7.1.1 By clause 1: The maximum amount of the parent company's loan and that the Taxpayer was to repay that loan subject to the terms set out in the agreement.

4.7.1.2 By clause 2: The sum advanced was to bear interest at a specified rate which was to be compounded annually.

4.7.1.3 By clause 3: That for so long as any monies remained outstanding from the Taxpayer to the banks under the loan agreement, refer paragraph 4.6 above, first, the loan 'shall not be subject to payment of interest (although interest may accrue thereon)', secondly, the parent company was not entitled to receive any amounts on account of the loan, thirdly, the loan was to remain unsecured and any right of set-off or counterclaim was excluded and, fourthly, the loan was subordinated to the loan from the banks and repayment by the Taxpayer of the loan was restricted in accordance with the terms of the shareholders subordination agreement, refer paragraph 4.7.2 below.

4.7.2 An agreement entitled (and hereinafter referred to as the 'shareholders subordination agreement') between the parent company, the Taxpayer, the Taxpayer's shareholders and the agent under the loan agreement. The purpose of this agreement was to exclude the right of the parent company to receive, demand or seek to recover the or any part of its loan to the Taxpayer prior to the banks having received all monies due to them under the loan agreement.

4.8 The banks and the parent company made their respective loans to the Taxpayer and the purchase of the property was completed.

4.9 When the Inland Revenue (Amendment) Ordinance No 17 of 1989 came into effect interest tax was abolished.

4.10 1987/88 year of assessment

4.10.1 On 7 June 1988, the Taxpayer submitted its 1987/88 profits tax return covering the period from 6 February 1987 to 30 September 1987. In a supporting schedule the Taxpayer provided the following analysis on interest expense charged in its accounts for that period.

	Reason for deductibility	Total $
Interest on loans to finance purchase of the investment property:		
Bank loans		13,902,178
Loans from associated companies		13,332,118

Interest on balance due to associated company	sections 16(1) & (2)(c)	136,095 27,370,391

4.10.2 In correspondence with the assessor the Taxpayer provided the following information relating to the recipients of the interest expense:

'(Recipients of) Interest on loans to finance the purchase of … property

(i) The Banks (Agent named) : $13,902,178

(ii) The Parent Company (named) : $6,666,059

(iii) The other subsidiary (named) : $6,666,059

4.10.3 Thereafter the assessor issued the following 1987/88 loss computation to the Taxpayer:

Loss per financial statements		$346,037
Add : Commercial rebuilding allowance		330,647
		$676,684
Less : Consultancy fees $(7,210 + 3,870)		11,080
Adjusted loss carried forward		$665,604

4.10.4 The Taxpayer did not make any objection to that computation.

4.11 1988/89 year of assessment:

4.11.1 On 2 May 1989, the Taxpayer submitted its 1988/89 profits tax return declaring an assessable profit of $688,252 for the period from 1 October 1987 to 30 September 1988. In a supporting schedule the Taxpayer provided the following analysis on interest expense charged in its accounts for that year:

	Reason for deductibility	Total $
Interest on loans to finance purchase of the investment property:		

Bank loans		21,466,587
Loans from associated companies		22,740,992
Interest on balance due to group company	sections 16(1) & (2)(c)	207,476
		44,415,055

4.11.2 By letter dated 10 May 1989 the Taxpayer submitted a revised claim for depreciation allowances and commercial building allowances, and requested the assessor to amend the 1987/88 loss computation to a loss of $3,951,669 to be carried forward.

4.11.3 It subsequently came to the attention of the assessor that the Taxpayer had completed 'NIL' interest tax returns for the years of assessment 1987/88 and 1988/89 in respect of interest payment to the parent company. In a letter dated 14 March 1989, the Taxpayer provided the following information relating to the interest expense to the parent company:

> '… During the accounting period from 1 April 1988 to 31 March 1989, we had paid or accrued interest expenses to three recipients. Out of which only one is not a company carrying on trade in Hong Kong. The [parent] company is the [Taxpayer's] ultimate holding company and has earned interest from [the Taxpayer] due to a subordinated loan extended to (the Taxpayer) in early 1987. However, we do not consider any interest tax is due as a result of the arrangement.'

4.12 The Taxpayer advanced the following contention in support of the 'NIL' interest tax returns:

> 'Clauses 3(a) and (b) of the (subordinated loan agreement) provides that the loan with (the [parent] company) is interest bearing and that the interest would only be payable as and when the [parent] company exercises its right for demand of payment. As no such demand has been made in the concerned periods and that the interest element accrued in our accounts is added to the outstanding principal for calculation of the interest ultimately payable upon receipt of demand from the [parent] company we submit that the interest booked in the accounts for accounting purposes is not yet received or credited for interest tax purposes. In fact, it has been explicitly stated in clause 3(b) that the [parent] company shall not be entitled to receive on account of the indebtedness prior to the date of final payment.'

4.13 Subsequent correspondence was exchanged in which the deductibility of the interest paid to the parent company was debated. On 13 September 1989 the assessor issued a letter of enquiry to the Taxpayer requesting further information relating to the claim for deduction of interest for the 1988/89 year

of assessment. Pending a reply to the enquiry, the assessor issued the following assessments to the Taxpayer:

4.13.1 1987/88 Profits Tax Assessment

Loss per revised computation	($3,951,669)
Add: Interest paid to the Parent Company	6,666,059
Assessable Profits	$2,714,390
Tax Payable thereon	$488,590

4.13.2 1988/89 Profits Tax Assessment

Assessable Profits	$688,252
Tax Payable thereon	$117,002

4.14 The Taxpayer objected to those assessments by letter dated 10 October 1989 and, subsequently, responded to the assessor's letter of 13 September 1989, refer paragraph 4.13 above, providing the following information:

1. [The parent company]

   Interest accrued : $11,370,496

2. [The co-subsidiary]

   Interest accrued : $11,370,496

Purpose of the loan was to finance the purchase of the [property].

Principal of the loan was as follows:

Drawndown Date	Amount of Principal
22-12-1986	$41,496,000
6-2-1987	87,104,000
	$128,600,000

Interest is capitalized on the anniversary of the drawndown date, and interest is then accrued on the combined balance.

4.15 Further information was subsequently provided with respect to the interest expense.

4.16 On 1 May 1990, the Taxpayer submitted its 1989/90 profits tax return declaring an assessable profit of $5,973,911 for the year ended 30 September 1989. In a supporting schedule filed with the 1989/90 profits tax return, the Taxpayer claimed, inter alia, that interest 'accrued' to the parent company (amounting to $6,436,317) for the period 1 October 1988 to 31 March 1989 should be allowed as tax deductible expenses pursuant to sections 16(1) and 16(2)(c) of the Inland Revenue Ordinance.

4.17 By letter dated 2 August 1990, the assessor requested the Taxpayer to provide further information relating to the 1989/90 accounts and advised that he would raise an assessment on the Taxpayer in the amount of the profit returned pending a reply. No objection was lodged by the Taxpayer (within the stipulated time limit) against that assessment. However, in a letter dated 21 September 1990, the Taxpayer requested an amendment (under section 70A of the Ordinance) to the 1989/90 profits tax assessment on the ground that '(there) was an omission of taxable loss brought forward of $3,263,417 which in turn is in dispute with (the) department and thus not yet agreed'.

4.18 The assessor considered that interest on loans from the parent company should not be allowed as tax deductible expenses and he therefore raised on the Taxpayer the following additional assessments:

4.18.1 1988/89 Additional Profits Tax Assessment

Additional Assessable Profits	$11,370,496
Additional Tax Payable thereon	$1,932,984

4.18.2 1989/90 Additional Profits Tax Assessment

Additional Assessable Profits	$6,436,317
Additional Tax Payable thereon	$1,061,992

4.19 By letter dated 20 December 1990, the Taxpayer objected against the above additional assessments. The grounds of objection included, inter alia, the following:

' (a) Interest amounting to $11,370,496 and $6,436,317 which "accrued" on the loan from the [parent] company in the year ended 30 September 1988 and 30 September 1989 should be deductible;

(b) There should be loss brought forward from the 1987/88 year of assessment and the loss should be available for set-off against profits of subsequent years.'

4.20 Apart from the question of deductibility of interest expense, the Taxpayer also requested an amendment of depreciation allowances and commercial building allowances. The assessor acceded to the company's revised claims for depreciation allowances and commercial building allowances for the 1987/88 year of assessment, the 1988/89 year of assessment and the 1989/90 year of assessment. However, he was still of the opinion that the interest expense concerned should not be an allowable deduction and considered that the profits tax assessment for the year of assessment 1987/88 and the additional profits tax assessments for the years of assessment 1988/89 and 1989/90 should be revised in the following manner:

4.20.1 1987/88 Profits Tax Assessment

Loss per revised computation	$3,624,112
Less: Interest on Subordinated Loan	6,666,059
Net Assessable Profits	$3,041,947
Tax Payable thereon	$547,550

4.20.2 1988/89 Additional Profits Tax Assessment

Profit per revised computation	$733,565
Add: Interest on Subordinated Loan	11,370,496
	$12,104,061
Less: Already assessed	688,252
Additional Assessable Profits	$11,415,809
Additional Tax Payable thereon	$1,940,687

4.20.3 1989/90 Additional Profits Tax Assessment

Profit per revised computation	$6,007,639
Add: Interest on Subordinated Loan	6,436,317
	$12,443,956

Less: Already assessed	5,973,911
Additional Assessable Profits	$6,470,045
Additional Tax Payable thereon	$1,067,557

4.21 Objections were taken to the tax assessment and the additional tax assessment and on 24 November 1992 the Commissioner issued his determination.

4.22 On 23 December 1992 notice of appeal and the grounds of appeal were filed by the Taxpayer.

5. SUBMISSIONS ON BEHALF OF THE TAXPAYER

The Taxpayer was represented by a partner of its solicitors. His submission was in writing supplemented by comment. This may be briefly summarised as follows:

5.1 Section 16(1):

> The interest claimed in the years of assessment 1987/88 and 1988/89 constitute expenses incurred in the production of profits in respect of which [the Taxpayer] was chargeable to tax. The liability arose during the relevant years pursuant to the subordinated loan agreement and although not paid pursuant to the shareholders subordination agreement that interest was 'incurred' and was 'payable' in those years of assessment.

5.2 Sections 16(l)(b) and 16(l)(g):

> Interest need not be paid to be 'incurred' and 'payable' and the use of the words 'paid' in section 16(l)(b) and 'expended' in section 16(l)(g) support that submission.

5.3 Section 16(2)(c):

> The loans from the group were not loans from a [local] financial institution or an overseas financial institution. Sums payable by way of interest need not be 'chargeable to tax' in the hands of the lender in the same basis period(s) in which those sums are 'incurred', 'payable' and 'deductible' by the borrower. The contrary interpretation means that 'incurred' and 'payable' are synonymous with 'paid', which is inconsistent with section 16(1).

5.4 CIR v COUNTY SHIPPING COMPANY LIMITED 3 HKTC 267 was to be distinguished on its facts as it did not decide whether or not interest had been incurred.

5.5 If, which was denied, 'incurred', and 'payable' have different meanings interest will be both 'incurred' and 'payable' when an unconditional obligation to pay that interest arises and, for that purpose, the interest need not be paid and payment need not be capable of immediate demand. Further, that an additional condition or requirement had to be fulfilled does not change 'incurred' or 'payable' status of the interest.

5.6 The representative then gave an extensive analysis of:

5.6.1 'incurred', during which he referred to LO & LO v CIR 2 HKTC 34, FEDERAL COMMISSIONER OF TAXATION v COMMONWEALTH ALUMINIUM CORPORATION 77 ATC 4 151. ODEON ASSOCIATED THEATRES LIMITED v JONES [1972] All ER 681 and cited a passage from W NEVILLE AND COMPANY LIMITED v FEDERAL COMMISSIONER OF TAXATION 56 CLR 290 at page 302.

5.6.2 'payable', during which he referred back to the NEVILLE case, EMU BAY RAILWAY COMPANY LIMITED v FEDERAL COMMISSIONER OF TAXATION 71 CLR 596 and NILSEN DEVELOPMENT LABORATORIES PTY LIMITED v FEDERAL COMMISSIONER OF TAXATION 11 ATR 505.

5.6.3 'chargeable to tax'. The Board was advised that the Taxpayer recognised that tax was payable on the payment of interest but that as payment had not been made no tax had fallen due for payment.

6. SUBMISSIONS ON BEHALF OF THE REVENUE

The Revenue was represented by senior crown counsel. He expanded on a written skeleton argument in which he confirmed there was no dispute as to the facts. The submission could be briefly summarised as follows:

6.1 Section 16(1):

The interest claimed in the years of assessment 1987/88 and 1988/89 were not an allowable expense under section 16(1) or section 16(l)(a) for the following reasons:

6.1.1 The COUNTY SHIPPING case decided that section 16(l)(a) limited and did not extend the meaning of section 16(1) whereby if the interest did not qualify under section 16(1)(a) it did not qualify at all.

6.1.2 It was not incurred within section 16(1).

6.2 Section 16(l)(a) and section 16(2):

The interest was not a qualifiable deduction as:

6.2.1 It was not 'payable' within the meaning of section 16(1)(a).

6.2.2 It did not satisfy any of the conditions of section 16(2), particularly sub-section (c).

6.3 Section 16(1):

6.3.1 The Board was bound by the COUNTY SHIPPING case and the cases were indistinguishable.

6.3.2 Even if the Board was not so bound the interest was not 'incurred' and the Board was referred back to Counsel's previous submission referred to at paragraph 6.1.2 above.

6.4 Section 16(1)(a):

It was accepted that to be 'incurred' or 'payable' interest need not be paid, for the Taxpayer to succeed it had to show that the interest:

6.4.1 had been 'incurred' (section 16(1));

6.4.2 was a sum 'payable' (section 16(1)(a)); and

6.4.3 was 'chargeable' to tax (section 16(2)(c)).

6.5 'Incurred' and 'payable':
The words have different meanings under the Ordinance.

6.5.1 'Incurred' was not limited as to time. The Board was referred to the LO & LO case and the passage in the final paragraph at page 52 quoting the judgment of Hunter J, at first instance.

6.5.2 'Payable' means 'payable now'. The word refers less to the liability created, the obligation which has become due, and more to the liability to make payment. This was supported by the fact that the word 'incurred' in section 16(1) is extended by the words 'during the basis period for that year of assessment' whilst 'payable' requires no qualifying wording because 'payable' is synonymous with 'payable now'.

6.5.3 That the drafters of the Ordinance intended 'incurred' and 'payable' to have different meanings was supported by the fact that 'incurred' is not repeated in section 16(1)(a). However, if the Board was not of the same view the Ordinance still required the interest to be 'incurred' and 'payable' during the

relevant basis period. It is not enough that the interest may have been 'incurred' only.

6.6 The documentation:

6.6.1 Was the interest 'payable' and 'chargeable' during the relevant basis periods on the proper construction of the subordinated loan agreement? It was to be noted that this document contained no specific repayment provision. Accordingly, this would have to be the subject matter of a separate agreement after the loan from the banks had been repaid. On the wording of the document that was also the position with respect to the interest. Not only was the repayment of the principal subject to the contingency that the Taxpayer would be able to repay the loan from the banks but so was the interest.

6.6.2 As the subordinated loan agreement reveals that, at the material times, there was no present or existing obligation to pay interest or any right to demand or receive interest, how could the interest be said either to have been 'incurred' or 'payable'.

6.7 'Chargeable to tax':

A submission was then made with respect the meaning and application of this expression. Particularly, it was submitted that even if the Board were to find that the interest had been 'incurred' and was 'payable' for it to be a valid deduction it also has to be chargeable to tax but as the interest had not been paid the Taxpayer had not effected payment of the tax. Further, interest tax was effectively abolished on 1 April 1989.

6.8 Accountancy Treatment:

Counsel referred the Board to WILLINGALE v INTERNATIONAL COMMERCIAL BANK LIMITED 52 TC 242 at page 266 as authority for the proposition that whilst the calculation of assessable profits must be ascertained in accordance with principles of commercial accounting, that is always subject to any relevant statutory provisions or overriding principles of tax law.

6.9 Authorities:

Counsel concluded by reminding the Board that foreign authorities were not binding on the Board particularly as there are a number of differences between Hong Kong Tax legislation and the legislation under consideration in those cases.

7. REPLY ON BEHALF OF THE TAXPAYER

The representative's reply was in writing and may be briefly summarised as follows:

7.1 'Incurred' and 'payable' have the same meaning. Although the parent company could not 'ask, demand, sue for, take or receive' the interest, the Taxpayer was subject to liability with respect thereto during the relevant basis periods.

7.2 The agreements between the Taxpayer, the parent company and another of its subsidiaries did not affect the nature of the liability but only the timing of the performance of the liability. It is important that the Ordinance does not refer to interest being 'due' but only to it being 'incurred' and 'payable'. An amount may be 'incurred' and 'payable' but not yet 'due'.

7.3 The Board was referred to additional authorities, namely RAVC INSURANCE PTY LIMITED v FEDERAL COMMISSIONER OF TAXATION 74 ATC 4 169, ALLIANCE HOLDINGS LIMITED v FEDERAL COMMISSIONER OF TAXATION 81 ATC 4 637 and FEDERAL COMMISSIONER OF TAXATION v AUSTRALIAN GUARANTEE CORPORATION LIMITED 84 ATC 4 642 dealing with the meaning of 'incurred'.

7.4 Documents:

In response to the submissions of the representative of the Revenue as to the documentation, the Board was addressed with respect to commercial reality and implicit obligations.

7.5 Accounting Treatment and Authorities:

The representative reminded the Board that accounting treatment was persuasive as were the decisions of overseas courts.

8. REASONS FOR THE DECISION

8.1 There is no dispute as to fact and the question before the Board requires an interpretation of section 16 of the Ordinance.

8.2 The LO & LO case:

The facts are sufficiently well known to obviate rehearsal. It is also well known that in the course of the case the words 'incurred' and 'payable' in the context of section 16 of the Ordinance are considered.

8.2.1 'incurred';

At page 72 of the report Lord Brightman's speech reads:

> 'For reasons already given, "an expense incurred" is not confined to a disbursement, and must at least include a sum which there is an obligation to pay, that is to say an accrued liability which is undischarged.'

8.2.2 'payable'

8.2.2.1 At page 71 of the report Lord Brightman's speech reads:

> 'In construing section 16, weight must be given to the fact that deductions are not confined to sums actually paid by the taxpayer. Such sums would be covered by the word "outgoings" standing alone. The contrast between "sums payable" in paragraph (a) and "rent paid" in paragraph (b) and the inclusion in paragraph (d) of "bad debts incurred" show clearly enough that the legislature was not thinking only of disbursements made during the basis period.'

8.2.2.2 He then posed the question:

> '... how far beyond disbursements is section 16 intended to travel or, more specifically, does the section travel far enough to comprise sums which the taxpayer seeks to deduct in the present case?'

He continued:

> 'Their Lordships turn to examine in more detail the precise nature of the retirement benefits in respect of which the deduction is claimed. It is correct to regard a retirement benefit as a sum payable in future, because there is no liability to pay until a future date arrives, namely the date when the employee leaves the firm's employment. Nevertheless the employee may leave when he pleases, so that the firm has no power to defer payment for any longer than the employee wishes. The right of the employee to receive his retirement benefit is absolute, in the sense that he need do nothing whatever except give a period of notice and pick up his money. True that he loses his entitlement if dismissed for dishonesty, serious misconduct or gross inefficiency before he gives notice or during the currency of the notice, but that does not make his right contingent. He has a vested right which is defeasible only in one possible but unlikely event. The corollary of the view that the long service employee has a vested right to his accrued lump sum payment is that the firm has an accrued liability for that sum.'

8.3 The COUNTY SHIPPING case:

8.3.1 This appeal from the determination of the Commissioner to the board came some four and a half years after the LO & LO case was finally determined.

8.3.2 This case, which is binding on the Board, is authority for the proposition:

> 'That section 16(l)(a) makes it clear that interest on money borrowed for the purposes of producing profits is deductible only if the provisions of the paragraphs of sub-section (2) are satisfied.'

8.3.3 At page 287 Fuad, V P stated:

> 'So far as interest is concerned, it seems to me that if the opening words of section 16(1) which occur before the word "including" are satisfied, the outgoing will have been incurred whether it has actually been paid or not.'

8.4 Section 16(2)(c):

As, in the wording of the headnote to the COUNTY SHIPPING case, section 16(l)(a) makes it clear that interest on money borrowed for the purposes of producing profits is deductible only if the provisions of the paragraphs of sub-section (2) are satisfied, what are the relevant provisions of sub-section 2(c)? This reads:

> (2) The conditions referred to in sub-section l(a) are that:
>
> (c) the money has been borrowed from a person other than a financial institution or an overseas financial institution and the sums payable by way of interest are chargeable to tax under the Ordinance;'

It was common ground that the parent company was not a financial institution or an overseas financial institution whereby the sole remaining question is whether the sums payable by way of interest are chargeable to tax under the Ordinance.

8.5 Liability of interest payments to tax:

8.5.1 The remaining question for the Board is whether the interest was chargeable to tax under the then section 28(1) of the Ordinance which provided that interest tax was to be charged on the recipient of any sum paid or credited to him in that year. It is common ground that no interest was paid to the parent company in respect of the interest on its loan to the Taxpayer during any of the relevant years of assessment as such payment was expressly prohibited by the subordinated loan agreement and the shareholders subordination agreement.

8.5.2 Under the then section 29 of the Ordinance, subject to certain exceptions which did not apply to the parent company, it was the obligation of the payer of interest to deduct the interest tax from the interest payment, deliver a certificate of deduction to the recipient and account to the Revenue for that deducted tax. In default, under the then section 30, the payer was liable to the Revenue for that tax but, pursuant to the then section 32, such was without prejudice to the payer's right to recover the tax from the recipient.

8.5.3 It is to be noted that the then section 28(1) used the expression 'paid or credited' as opposed to 'payable or creditable' whereby, and applying the interpretation adopted by the Judicial Committee of the words or expressions 'payable', 'rent paid and bad debts incurred' in the LO & LO case, the obligation to tax arose in the financial year of the recipient in which the interest was paid or credited as opposed to its actual financial year(s) in which the liability to interest was incurred by the borrower. See also the quotation from the judgment of Fuad V P in the COUNTY SHIPPING case at paragraph 8.3 above. The Board is of the opinion that the wording selected by the legislature recognised that commercial practice is for interest to be payable in arrears as a result of which the liability to pay interest could be 'incurred' partly or wholly in the borrower's financial year which fell within one year of assessment whilst it might only be paid or credited in the lender's financial year which might fall in a subsequent year of assessment.

8.5.4 Had interest tax not been abolished when the parent company and the Taxpayer were freed from the restrictions imposed by the subordinated loan agreement and the shareholders subordination agreement and the Taxpayer had paid the interest that had been incurred to the date of payment to the Revenue, no doubt, would have looked for the tax on the interest paid from the Taxpayer and had the Taxpayer failed to deduct that tax the Revenue would have recovered it from the Taxpayer.

8.5.5 The Board notes that the facts, refer paragraph 4.11.3 above, disclose that it came to the attention of the assessor that the Taxpayer had completed 'NIL' interest tax returns for the years of assessment 1987/88 and 1988/89 in respect of interest payment to the parent company. If, as the Commissioner contends, tax was not payable on the interest why would the assessor feel it necessary to follow this up which, on the facts, he did?

8.6 Findings:

8.6.1 As to 'incurred' and 'payable':

For the purposes of its decision, the Board is satisfied that:

8.6.1.1 The interest was 'incurred', in other words it was a sum which there was an obligation to pay, that is to say an accrued liability which was undischarged.

8.6.1.2 The interest was ‘payable’, in other words the fact that it was not ‘paid’ during the relevant basis periods is irrelevant.

8.6.2 As to section 16(2)(c):

That at the material times the sums payable by way of interest were chargeable to tax under the Ordinance by operation of the then section 28(1) and, accordingly deductible.

9. DECISION

For the reasons given the Board allows this appeal and orders the discharge of the following:

9.1 The notice of additional assessment for profits tax for the year of assessment 1988/89 and notice of additional demand for tax issued on 28 November 1990; and

9.2 The notice of additional assessment for profits tax for the year of assessment 1989/90 and notice of additional demand for tax issued on 28 November 1990.