Case No. D34/04

Profits tax – interest expenses attributable to the payment of dividend – section 16(1)(a) of the Inland Revenue Ordinance ('IRO').

Panel: Colin Cohen (chairman), James Julius Bertram and Michael Neale Somerville.

Dates of hearing: 10 and 11 May 2004.
Date of decision: 25 August 2004.

The taxpayer was assessed and objected to the additional profits tax for the years of assessment 1998/99, 1999/2000, 2001/02 and to the profits tax assessment for 2000/01 and 2001/02, all on the basis that the loan interest attributed to the payment of dividend in the year ended 28 February 1999 was not allowable for deduction as an interest expense.

In his determination, the Acting Commissioner increased the additional tax payable under additional profits tax assessment for the year of assessment 1998/99 to correct an arithmetical error and upheld the additional tax assessments for 1999/2000, 2001/02 and the profits tax assessments for 2000/01 and 2001/02.

The taxpayer appealed.

Held:

1. For an item of expenditure to be deductible, there must be a link or connection between the incurring of the expenditure and the profit producing activities of the taxpayer.

2. The Board found it clear that the loans were obtained for the purpose of paying the dividends and the interest expenses attributable to the dividend payment cannot be said to be incurred in the production of the taxpayer's profits.

Appeal dismissed.

Cases referred to:

Federal Commissioner of Taxation v Roberts & Smith (1992) 23 ATR 494
D4/04 (unpublished)
Federal Commissioner of Taxation v Riverside Road Pty Ltd (1990) 21 ATR 499
Commissioner of Inland Revenue v Cosmotron Manufacturing Co Ltd [1997] HKLRD 1161
Archibald Thomson, Black and Co Ltd v Batty (1919) 7 TC 158
Hamilton v The Commissioner of Inland Revenue (1931) 16 TC 213
Commissioner of Inland Revenue v G Brollo Properties (Pty) Ltd (1993) 56 SATC 47
Commissioner of Inland Revenue v Elma Investments CC (1996) 58 SATC 295
Ticktin Timbers CC v Commissioner for Inland Revenue (1999) 16 SATC 399
So Kai Tong Stanley v Commissioner of Inland Revenue (HCIA 4/2002)
Fletcher v The Commissioner of Taxation of the Commonwealth of Australia (1991) 173 CLR
The Federal Commissioner of Taxation v Munro (1926) 38 CLR 153

Stewart Wong Counsel instructed by Department of Justice for the Commissioner of Inland Revenue.
Denis Yu Counsel instructed by Messrs Ford, Kwan & Co, Solicitors & Notaries, for the taxpayer.

Decision:

Introduction

1. This is an appeal by Company A ('the Taxpayer') in respect of the determination of the Acting Commissioner of Inland Revenue dated 23 October 2003. In that determination, the Acting Commissioner overruled the Taxpayer's objection and confirmed the following:

(1) Additional profits tax assessment for the year of assessment 1998/99 under charge number 1-1116751-99-0, dated 18 December 2001, showing additional assessable profits of $33,005,835 with additional tax payable thereon of $5,280,933 is hereby increased to additional assessable profits of $33,095,835 with additional tax payable thereon of $5,295,333.

(2) Additional profits tax assessment for the year of assessment 1999/2000 under charge number 1-1102504-00-7, dated 18 December 2001, showing additional assessable profits of $27,789,529 with additional tax payable thereon of $4,446,325 is hereby confirmed.

(3) Profits tax assessment for the year of assessment 2000/01 under charge number 1-1096580-01-0, dated 7 June 2002, showing assessable profits of $25,281,020 with tax payable thereon of $4,044,963 is hereby confirmed.

(4) Profits tax assessment for the year of assessment 2001/02 under charge number 1-1082976-02-2, dated 24 January 2003, showing assessable profits of $5,407,241 with tax payable thereon of $865, 158 is hereby confirmed.

(5) Additional profits tax assessment for the year of assessment 2001/02 under charge number 1-1097981-02-7, dated 18 June 2003, showing additional assessable profits of $31,040,779 with additional tax payable thereon of $4,966,525 is hereby confirmed.

2. The sole ground upon which the Taxpayer challenges the determination is the deductibility of interest expenses of the Taxpayer which it incurred to various parties by reason of and as a result of declarations of dividends, which dividends (or equivalent amounts thereof) were then credited to the accounts of the shareholders or their respective associates as loans with interest charged thereon.

3. The Taxpayer relies on section 16(1)(a) of the Inland Revenue Ordinance ('IRO') which provides:

> '*In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period, including –*
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> *(a) where the conditions set out in subsection (2) are satisfied, sums payable by such person by way of interest upon any money borrowed by him for the purpose of producing such profits, and sums payable by such person by way of legal fees, procuration fees, stamp duties and other expenses in connection with such borrowing;'*

4. The issue is whether the interest expenses, paid in respect of the declared but unpaid dividends, is allowable for deduction. The Acting Commissioner found that the loans were clearly originated from the dividend payable by the company to its shareholders and the direct purpose of the loans was for the dividend payment and therefore the interest expenses attributable to the dividend payment cannot be said to have been incurred in the production of the Taxpayer's assessable profits.

The agreed facts

5. The following facts as set out in the 'Statement of Agreed Facts' were agreed by the parties and we find them as facts.

(a) The Taxpayer is a private company incorporated in Hong Kong on 29 September 1970. Its issued and fully paid share capital was $990,000 divided into 9,900 shares of $100 each and the shareholders were:

	No of shares held
Company B	9,600
Company C	100
Company D	100
Company E	100
	9,900

Its principal activities were the letting and sale of properties.

(b) The shareholders of Company B were:

	No of shares held
Company C	3,333
Company D	3,333
Company E	3,333
	9,999

(c) In the year ended 28 February 1999, the Taxpayer made two declarations of dividend payable to its shareholders, namely:

(i) on 1 July 1998, an interim dividend of $40,000 per share, in the total amount of $396,000,000; and

(ii) on 28 February 1999, a final dividend of $60.00 per share, in the total amount of $594,000.

(d) On 1 July 1998, Company B declared an interim dividend payable to its shareholders of $38,403.840384 per share, in the total amount of $384,000,000 – a sum equivalent to the amount of interim dividend receivable by Company B from the Taxpayer.

(e) The book entries made in the Taxpayer's accounts, following and in connection with its declaration of interim dividend on 1 July 1998, were:

			$	$
1-7-1998	Dr	Dividend paid	396,000,000	
	Cr	Company B		384,000,000
	Cr	Company C		4,000,000
	Cr	Company D		4,000,000
	Cr	Company E		4,000,000
/////////	//	/////////	//////////	//////////
1-7-1998	Dr	Company B	384,000,000	
	Cr	Company F		128,000,000
	Cr	Company G		128,000,000
	Cr	Company E		128,000,000
/////////	//	//////////	//////////	///////////
1-7-1998	Dr	Company C	4,000,000	
	Dr	Company D	4,000,000	
	Cr	Company F		4,000,000
	Cr	Company G		4,000,000

(f) The book entries made in the Taxpayer's accounts, following and in connection with its declaration of final dividend on 28th February, 1999, were:

			$	$
28-2-1999	Dr	Dividend paid	594,000	
	Cr	Company B		576,000
	Cr	Company C		6,000
	Cr	Company E		6,000
	Cr	Company D		6,000
/////////	//	////////////	/////////	///////////
28-2-1999	Dr	Company C	6,000	
	Dr	Company D	6,000	
	Cr	Company F		6,000
	Cr	Company G		6,000

(g) (i) The Taxpayer was assessed to additional profits tax for the years of assessment 1998/99 and 1999/2000 on the basis that the loan interest, attributed by the assessor to the payment of dividend in the year ended 28 February 1999, was not allowable for deduction as an interest expense.

(ii) The Taxpayer objected to those additional profits tax assessments.

(h) On 1 March 2000, the amount owed by the Taxpayer to Company G was repaid by means of a new unsecured interest-bearing loan from Credit Company H to the Taxpayer.

(i) (i) The Taxpayer was assessed to profits tax for the year of assessment 2000/01 on the basis that the loan interest, attributed by the assessor to the payment of dividend in the year ended 28 February 1999, was not allowable for deduction as an interest expenses.

(ii) The Taxpayer objected to that profits tax assessment.

(j) On 1 July 2001, the amount owed by the Taxpayer to Credit Company H was repaid by means of a new unsecured interest-bearing loan from Finance Company I to the Taxpayer.

(k) (i) On 24 January 2003, a notice of assessment of profits tax for the year of assessment 2001/02 was issued to the Taxpayer.

(ii) The Taxpayer objected to that assessment on the grounds that but for the incorrect profits tax assessment for the year of assessment 2000/01, there would have been assessable losses of $3,347,418 brought forward and available for set-off in the year of assessment 2001/02.

(l) (i) The Taxpayer was assessed to additional profits tax for the year of assessment 2001/02 on the basis that loan interest, attributed by the assessor to the payment of dividend in the year ended 28 February 1999, was not allowable for deduction in the computation of assessable profits.

(ii) The Taxpayer objected to that additional profits tax assessment.

(m) (i) The amount of interest-bearing loans from respectively:

(1) Company F;

(2) Company G (as from 1 March 2000, Credit Company H, and as from 1 July 2001, Finance Company I); and

(3) Company E.

was identical at any particular time.

(ii) The amount of interest charged on those loans in any particular period was calculated at a uniform rate of interest.

(n) By determination dated 23 October 2003, the Acting Commissioner:

(i) Increased the amount of additional tax payable under additional profits tax assessment for the year of assessment 1998/99 from $5,280,933 to $5,295,333, to correct an arithmetical error; and

(ii) Upheld:

(1) Additional profits tax assessment for the year of assessment 1999/2000;

(2) Profits tax assessments for the years of assessment 2000/01 and 2001/02; and

(3) Additional profits tax assessment for the year of assessment 2001/02.

The evidence

6. The Taxpayer called two witnesses to give evidence in respect of this matter, Mr J and Mr K.

7. Mr J's evidence was that the Taxpayer was a two-project company that dealt with the development of industrial buildings in the Hong Kong Island and had a share in a residential complex. Mr J's evidence was that the Taxpayer's working capital was previously funded by interest free loans from its shareholders as well as bank loans until 1994. From 1994 onwards, the Taxpayer's chief sources of finance for working capital, apart from shareholders' equity and trade payables comprised interest free loans from its shareholders. From the 1 March 1996, the Taxpayer began paying interest on the shareholders' loans. The reason giving for the payment of interest was due to the fact that the Taxpayer was receiving by then a steady stream of rental income.

8. By 1993, the two developments had been completed and the Taxpayer had begun earning profits from the sale of the units as well as rental income being derived from the ownership of those units which it retained.

9. Mr J stated that prior to 1998, there had only been one declaration and payment of dividend by the Taxpayer to his shareholders, this was in the accounting year ended 28 February 1991 and this was in the sum of $198,049,500.

10. On 28 February 1998 as shown in its audited balance sheet for that date, the balance on the Taxpayer's profit & loss account stood at $407,819,437.03 which represented the accumulated undistributed profits. These were profits that were generated on the Taxpayer's working capital consisting, in the main of advances from shareholders. Mr J confirmed that these were returns on investments made in the Taxpayer by its joint venture partners down the various years. He asserted that these profits had been retained as working capital for the Taxpayer's continuing business of maintaining its portfolio of rental properties. However, by that date, the Taxpayer had completed the developments.

11. We, having heard the evidence of both Mr J and Mr K, find that by 1993, the two developments had been completed, the Taxpayers had been earning profits from the sale of units, as well as receiving rental income from the ownership of those units which it retained. Apart from this, there had been no other business conducted by the Taxpayer at any time.

12. When the various dividends were declared, no cash payments were involved at all. Mr J in his evidence stated that the declaration by the Taxpayer of the interim dividend out of the retained profits meant, in effect, the withdrawal by the joint venture partners of what had been interest-free finance used by the Taxpayer (that is, substantial profits hitherto locked up) as working capital. He stated that it therefore became necessary for the Taxpayer to raise fresh working capital in order to continue its operations. He asserted that the fresh working capital took the form of additional interest-bearing loans from Company F, Company G and Company E respectively for the sums equivalent to the dividend amounts to due the joint venture partners.

13. The Taxpayer through its Counsel, Mr Yu, submitted that new working capital was required and as such, the retained profits were financing the continuing operation of the Taxpayer. Mr Yu supported his proposition by relying upon the Australian tax case of Federal Commissioner of Taxation v Roberts & Smith (1992) 23 ATR 494. The Taxpayer also relied on the Australian Taxation Ruling TR95/25 entitled 'Income Tax': deductions for interest under sub-section 51(1) of the Income Tax Assessment Act 1936 following FCT v Roberts (1992) 23 ATR 494 and FCT v Smith (1992) 23 ATR 494.

14. We have considered a recent decision of a Board of Review in D4/04 (unpublished). The Board in that case having been referred to Federal Commissioner of Taxation v Roberts & Smith (1992) 23 ATR 494 stated as follows:

> *'Having read those cases and listened to [Mr X's] submission, we are unable to see the relevance of these authorities. We do not propose to deal with them in any detail. The wording of the Australian legislation considered in these cases is different from that of our section 16(1)(a); and we are unable to derive any principle of law from either of those cases which can assist the taxpayer.'*

We also agree with the conclusions reached by the Board in D4/04.

The Commissioner's submissions

15. Counsel for the Commissioner reminded us that the burden is on the Taxpayer to show that the assessment appealed against is excessive or incorrect, section 68(4) of the IRO. Counsel drew our attention to the following authorities:

(a) Federal Commissioner of Taxation v Riverside Road Pty Ltd (1990) 21 ATR 499;

(b) Federal Commissioner of Taxation v Roberts (1992) 23 ATR 494;

(c) Commissioner of Inland Revenue v Cosmotron Manufacturing Co Ltd [1997] HKLRD 1161;

(d) Archibald Thomson, Black and Co Ltd v Batty (1919) 7 TC 158;

(e) Hamilton v The Commissioner of Inland Revenue (1931) 16 TC 213;

(f) Commissioner of Inland Revenue v G Brollo Properties (Pty) Ltd (1993) 56 SATC 47;

(g) Commissioner of Inland Revenue v Elma Investments CC (1996) 58 SATC 295;

(h) Ticktin Timbers CC v Commissioner for Inland Revenue (1999) 16 SATC 399;

(i) So Kai Tong Stanley v Commissioner of Inland Revenue (HCIA 4/2002);

(j) Fletcher v The Commissioner of Taxation of the Commonwealth of Australia (1991) 173 CLR;

(k) The Federal Commissioner of Taxation v Munro (1926) 38 CLR 153.

Our analysis

16. Counsel for the Commissioner submitted that for an item of expenditure to be deductible, there must be a link or connection between the incurring of the expenditure and the profit producing activities of the taxpayer. To be deductible the expenditure must have been made

for the purpose of earning the profits and not just made out of profits of the trade. We agree with these submissions.

17. We find the decision of Ticktin Timbers CC v Commissioner for Inland Revenue (1999) 61 SATC 399 is of assistance. We rely on the judgment of Hefer JA of the Supreme Court of Appeal of South Africa which stated as follows:

> '*[7] … the loan was not needed for the appellant's income-producing activities and that the intention was to increase [the shareholder's] income, and not that of the appellant. The liability for the interest was accordingly not incurred in the production of the latter income …*
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> *[8] There is another way of looking at the matter which leads to the same result. It is trite that interest paid on a loan which was raised in order to enable a dividend to be paid is not expenditure incurred in the production of income and is therefore not deductible. A company or corporation is not obliged to pay a dividend or make a distribution respectively irrespective of the financial circumstances in which it finds itself. If, after doing so, it will have the resources to enable it to continue its income-earning activities without having to borrow simultaneously an equivalent amount no problem arises. When it will not, but nonetheless pays a dividend or makes a distribution and simultaneously raises a loan in exactly the same amount, it becomes a question of whether or not the purpose of the loan was to enable a dividend to be paid or the distribution to be made or to provide the entity with liquid funds required to enable it to pursue its income-earning activities.*
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> *[9] What happened in this case? Simply put it amounts to this. Appellant had enough money in its coffers to finance its income earning operations without borrowing and incurring an obligation to pay interest. It was under no obligation to use that money to make a distribution and its controlling mind (that of [the shareholder]) was well aware that, if it was used for that purpose, it would be necessary to borrow simultaneously an equivalent amount and pay interest on the loan. It is quite clear that the relevant transactions, namely, the making of the distribution on the one hand, and the making of the loan, on the other, were not intended to be separate and unconnected transactions. They were plainly interdependent and neither was intended to exist without the other. It is this linkage which, in my mind, is fatal for appellant's case for it shows that the true reason why appellant had to borrow back at interest from [the shareholder] money which it had had in its own coffers and was under no obligation to part with, was because it wanted to make a distribution to [the shareholder] … What is of moment, as counsel for appellant rightly emphasised, is why appellant incurred the interest-bearing debt. As I have*

said, the answer seems plain: because it wished to make a distribution to [the shareholder]. The interest was therefore not deductible.

…

[13] There is a clear conceptual distinction between, on the one hand, a case in which a company in good faith and on the strength of inaccurate financial statements furnished by employees declares and pays a dividend, but shortly thereafter learns the true financial position of the company and realizes that the dividend should not have been paid and that an equivalent sum will have to be borrowed to finance the company's trading activities and, on the other, a case such as the present. In the present case the purpose of the loan was to enable a distribution to be made to [the shareholder]. Without the loan there would have been no distribution; without the distribution there would have been no loan. In the former case the interest paid will be deductible for the loan was not procured in order to pay the dividend. The fact that the payment of the dividend was the historical cause of the company needing to borrow is irrelevant. The purpose of the borrowing was to finance the company's trading operations after it had parted with its own resources while under the misapprehension that it could afford to do so.'

18. As can be seen, the Supreme Court of Appeal of South Africa concluded that the interest paid on the loan which was raised in order to enable the dividend to be paid is not an expenditure incurred in the production of income and as such, it is not therefore deductible. Indeed, the facts in Ticktin Timbers CC v Commissioner for Inland Revenue (1999) 16 SATC 399 are very similar to the facts before this Board. We would also mention that the South African legislation in respect of deductions, section 11(a) of the Income Tax Act 58 of 1962 is similar to section 16(1)(c) of the IRO in that it refers to deductions incurred in the production of income.

19. Both Mr J and Mr K in their evidence stated that the effect of the transactions (declarations and loans) was to create a liability of the Taxpayer and ultimately reduce its profits. Indeed, Mr J confirmed that the purpose of the transactions was to allow the distributions to be made whilst Mr K said that the purpose was to allow shareholders to earn interest income. Therefore, we conclude that the purpose was not to produce the chargeable profits of the Taxpayer but to reduce them.

20. The Taxpayer in its submissions argued before us that the loans made were to replenish its working capital after distribution. We are not able to agree with such submissions. There was no evidential basis to support the argument that fresh working capital was needed in the light of the continuing operations of the Taxpayer having regard to its financial circumstances and if such working capital was needed, then the directors should not have recommended paying a dividend since the Taxpayer was not in a position to pay one.

Conclusion

21. It is clear that the loans were obtained for the purpose of paying the dividends and the interest expenses therefore attributable to the dividend payment cannot be said to be incurred in the production of the Taxpayer's profits. Therefore, we dismiss the Taxpayer's appeal.