

Case No. D35/07

Profits tax – whether to allow interest expenses in computing the appellant’s profits or loss – sections 68(4) and 68(9) of the Inland Revenue Ordinance (‘IRO’) – frivolous and vexatious appeal

Panel: Kenneth Kwok Hing Wai SC (chairman), Susan Beatrice Johnson and Richard Leung Wai Keung.

Date of hearing: 14 September 2007.

Date of decision: 27 November 2007.

The appellant objected to the profits tax assessments. Company B lent a total of \$8,000,000 to the appellant on 1 October 1993. The appellant was dormant from 1995/96 to 1997/98. Throughout the years of assessment 1994/95 to 2000/01, the appellant made various loans to its associated companies and a shareholder. The loans were interest free. There is no evidence on why the \$8,000,000 Company B loans were raised. The issue is the assessor’s disallowance of some interest expenses in computing the appellant’s profits or loss.

The tax representative of the appellant has failed to comply with section 66(1) and (3) in that notice of appeal was not given to the Clerk and no application has been made for permission to amend the grounds of appeal. The tax representative also declines to agree any facts at all.

Held :

1. In the absence of agreement, the party making the assertion should prove it, bearing in mind section 68(4) which provides that ‘the onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant’. Facts not in dispute should be agreed. It is in the interests of both the taxpayers and the revenue to try to agree as many facts as they can (D65/00, IRBRD, vol 15, 610 considered).
2. There is no evidence on the extent, if at all, to which the interest expenses were incurred by the appellant in the production of profits in respect of which it was chargeable to profits tax for any period. For the years of assessment 1998/99 to 2000/01, the question is whether an apportionment of the interest expenses should be made to exclude the non-income producing component. The Board is bound by authority to hold in favour of apportionment (Zeta Estates Limited v Commissioner of

(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS

Inland Revenue [2007] 2 HKLRD 102 and So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416 considered). The appellant has not discharged the onus of proving on a balance of probabilities that any of the assessments appealed against is incorrect or excessive.

3. The Board is of the opinion that this appeal is frivolous and vexatious and an abuse of the process. Pursuant to section 68(9) of the IRO, the Board orders the appellant to pay the sum of 5,000 as costs of the Board, which \$5,000 shall be added to the tax charged and recovered therewith.

Appeal dismissed and costs order in the sum of \$5000 imposed.

Cases referred to:

D65/00, IRBRD, vol 15, 610

Zeta Estates Limited v Commissioner of Inland Revenue [2007] 2 HKLRD 102

So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416

Clayton's (1816) 1 Mer 572

Commissioner of Inland Revenue v Malaysian Airline System Bhd [1992] 2 HKC 468

Alvin Mok Yu Him and Lesile Chan Yuk Kin of J Enterprise Secretarial & Taxation Limited for the taxpayer.

Lai Wing Man and Chan Wai Yee for the Commissioner of Inland Revenue.

Decision:

1. This is a purported appeal against the Determination of the Acting Deputy Commissioner of Inland Revenue dated 10 July 2007 whereby:

- (a) Profits tax assessment for the year of assessment 1998/99 under charge number 1-1125499-99-9, dated 25 January 2005, showing net assessable profits of \$719,279 (after loss set-off of \$69,792) with tax payable thereon of \$115,084 was confirmed.
- (b) Profits tax assessment for the year of assessment 1999/2000 under charge number 1-1117705-00-3, dated 25 January 2005, showing assessable profits of \$8,253 with tax payable thereon of \$1,320 was confirmed.

(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (c) Profits tax assessment for the year of assessment 2002/03 under charge number 1-1108033-03-0, dated 25 January 2005, showing net assessable profits of \$1,164,937 (after loss set-off of \$36,814) with tax payable thereon of \$186,389 was confirmed.
- (d) Profits tax assessment for the year of assessment 2003/04 under charge number 1-1087899-04-2, dated 25 January 2005, showing assessable profits of \$1,135,530 with tax payable thereon of \$198,717 was confirmed.

Purported notice of appeal

2. By letter dated 12 July 2007, Ms A of J Enterprise Secretarial & Taxation Limited purported to give notice of appeal on behalf of the appellant on the following grounds (written exactly as it stands in the original):

- ‘(1) That the assessments are excessive
- (2) That the interest expenses have been wrongly disallowed
- (3) That the Deputy Commissioner has misdirected herself in the applicability of the Clayton’s Rule to this case
- (4) That the Deputy Commissioner has failed to determine the Objection against the 2004/05 assessment, which involves the same issue as the Profits Tax assessments raised on the earlier years (see paragraph 5 of Appendix D to the Determination).’

3. Appendix D to the Determination is a copy of the letter dated 5 May 2007 written by Ms A of J Enterprise Secretarial & Taxation Limited to the assessor. Paragraph 5 reads as follows (written exactly as it stands in the original):

‘Thirdly, as to the 2004/05 assessment, your Department has, more often than not, expressed that when it is a matter of Form and Substance, Form will prevail over Substance. You cannot seek to have your cake and eat it. In the present case, the case Assessor cannot deny that a “Notice of Assessment” for 2004/05 was issued. Tax in the form of tax overpaid and refundable was duly calculated. Unless your Department is prepared to retract on the issue of that Notice or to admit that it was an assessing mistake, it is only just and fair that the 2004/05 Notice be treated as a Notice of Assessment, vulnerable to objection and appeal process.’

Non-compliance with section 66(1)

(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS

4. Section 66(1) of the Inland Revenue Ordinance, Chapter 112, provides that no notice of appeal shall be entertained unless it is given in writing to the Clerk to the Board. This statutory requirement is simple and straight forward. A copy of section 66 was attached to the covering letter enclosing the Determination. Section 66 provides that:

'(1) Any person (hereinafter referred to as the appellant) who has validly objected to an assessment but with whom the Commissioner in considering the objection has failed to agree may within –

(a) 1 month after the transmission to him under section 64(4) of the Commissioner's written determination together with the reasons therefor and the statement of facts; or

(b) such further period as the Board may allow under subsection (1A),

either himself or by his authorized representative give notice of appeal to the Board; but no such notice shall be entertained unless it is given in writing to the clerk to the Board and is accompanied by a copy of the Commissioner's written determination together with a copy of the reasons therefor and of the statement of facts and a statement of the grounds of appeal.

...

(3) Save with the consent of the Board and on such terms as the Board may determine, an appellant may not at the hearing of his appeal rely on any grounds of appeal other than the grounds contained in his statement of grounds of appeal given in accordance with subsection (1).'

5. J Enterprise Secretarial & Taxation Limited's letter was addressed to the Chairman of the Board of Review. It does not comply with section 66(1) in that it was not given to the Clerk. Section 66(1) mandates that it shall not be entertained.

6. Nobody from J Enterprise Secretarial & Taxation Limited made any attempt to cure the defect. There is thus no valid notice of appeal before the Board and the purported appeal should be dismissed for want of a valid notice of appeal.

7. We shall nevertheless consider this purported appeal on the assumption that it were open to us to entertain the purported notice of appeal.

Second letter from J Enterprise Secretarial & Taxation Limited dated 12 July 2007

(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS

8. Ms A of J Enterprise Secretarial & Taxation Limited wrote another letter dated 12 July 2007 to the Chairman of the Board to 'include an additional Ground of appeal' which reads as follows (written exactly as it stands in the original):

'(5) That the Statement of Facts based on which the Deputy Commissioner of Inland Revenue arrived at her determination has not been agreed by the Company in entirety, as the Appeals Officer has selectively adopted some proposed amendments to her draft Statement of Facts, while discarding other proposed amendments to her draft.'

Non-compliance with section 66(1) and (3)

9. This letter is again addressed to the Chairman of, instead of the Clerk to, the Board of Review. It does not comply with section 66(1).

10. Further, no taxpayer may amend his/her/its grounds of appeal as of right. Section 66(3) makes it clear that consent of the Board is required.

11. No application has been made by or on behalf of the appellant for permission to amend the grounds of appeal. In the absence of the Board's consent, the appellant may not rely on the proposed additional ground.

Facts should be proved in the absence of agreement

12. In any event, the proposed additional ground is misconceived. The appellant made no attempt to identify the facts agreed by it. There is no statement of agreed facts. In the absence of agreement, the party making the assertion should prove it, bearing in mind section 68(4) which provides that *'the onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant'*.

13. As the Board (Kenneth Kwok Hing Wai SC, Berry Hsu Fong Chung and Vincent Mak Yee Chuen) said in paragraph 4 in D65/00, IRBRD, vol 15, 610, the purpose of having agreed facts is to facilitate the hearing of the appeal so that the Board and the parties may concentrate on the facts in issue.

'... the purpose of a statement of facts is to facilitate the hearing of the appeal. Unless there is absolutely no common ground, an agreed statement of facts sets out the facts which are agreed by the parties to the appeal so that the Board of Review and the parties may concentrate on the facts in issue.'

14. Facts which are not in dispute should be agreed.

(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS

15. It is in the interests of both the Taxpayers and the Revenue to try to agree as many facts as they can.

16. Taxpayers (or their representatives) who decline to try to agree any facts at all are being unhelpful to the taxpayers because, absent agreement, the taxpayers will have to prove every fact material to the success of the appeal.

17. If the Revenue should, for example, decline to agree facts which should not be in dispute, e.g. the facts in the 'Facts upon which the Determination was arrived at' section in the Determination, the Revenue is being unhelpful to the Board, unless the Revenue has good cause for not agreeing any particular fact.

The appeal hearing

18. At the hearing of the appeal, the appellant was represented by Mr Alvin Mok Yu-him and Mr Lesile Chan Yuk-kin of J Enterprise Secretarial & Taxation Limited and the respondent was represented by Ms Lai Wing-man, senior assessor, and Ms Chan Wai-ye, assessor.

19. Neither party called any witness.

20. Mr Alvin Mok Yu-him read from a document called 'Submission by the Appellant's Representatives'.

21. Ms Lai Wing-man had prepared a comprehensive written submission and she supplemented it with oral submission and answers to questions or comments from the panel members.

Interest expenses in issue

22. What is in issue in this purported appeal is the assessor's disallowance of some interest expenses in computing the appellant's profits or loss.

Findings of facts based on documentary evidence

23. Based on the documents placed before us, including in particular, the appellant's financial statements, we make the following findings of fact.

24. By two lending agreements both made under section 18(2) of the Money Lenders Ordinance, Chapter 163, and both dated 1 October 1993, Company B lent a total of \$8,000,000 to the appellant at an interest rate of 0.6% per month and repayable on demand.

(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS

25. In Note 7 of the Notes to the Accounts as at 31 March 1995 for the period from 1 January 1977 to 31 March 1995, the appellant stated that:

‘The Company ceased trading on 31 December 1976 and remained dormant until the year commencing 1 April 1994 when it recommenced trading. No accounts have been prepared for the period 1 January 1977 to 31 March 1994.’

26. The appellant’s profit and loss accounts for the years ended 31 March 1995 to 2004 showed, among others, the following particulars:

	<u>1994/95</u>	<u>1995/96</u>	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>
	\$	\$	\$	\$	\$
Interest received	108,296	-	-	-	-
Sales	-	-	-	-	25,879,006
Cost of sales	-	-	-	-	(24,894,063)
Gross profits	108,296	-	-	-	984,943
Interest expenses	(584,072)	(586,136)	(584,000)	(617,067)	(778,666)
Other expenses	(10,980)	(21,235)	(11,950)	(15,550)	(195,593)
Profit/(Loss)	(486,756)	(607,371)	(595,950)	(632,617)	10,684
	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>	<u>2002/03</u>	<u>2003/04</u>
	\$	\$	\$	\$	\$
Sales	7,856,377	2,310,000	-	13,932,282	35,749,879
Cost of sales	(7,513,267)	(2,210,000)	-	(12,682,534)	(34,548,389)
Gross profits	343,110	100,000	-	1,249,748	1,201,490
Sundry income	-	-	906,666 *	-	-
	343,110	100,000	906,666 *	1,249,748	1,201,490
Interest expenses	(780,800)	(778,666)	-	-	-
Other expenses	(172,243)	(151,979)	(11,650)	(47,997)	(65,960)
Profit/(Loss)	(609,933)	(830,645)	895,016	1,201,751	1,135,530

* This represented interest for the period from 1 February 2000 to 31 March 2001 payable to and forgone by Company B as the appellant was unable to repay.

27. The appellant’s balance sheets as at 31 March 1995 to 2004 showed, among others, the following particulars:

	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>
	\$	\$	\$	\$	\$
Interest in associated companies					

(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS

Company C					
Share capital	1,000,000	1,000,000	1,000,000		
Current account *	1,908,296	1,908,296	1,908,296		
	<u>2,908,296</u>	<u>2,908,296</u>	<u>2,908,296</u>		
Company D					
Share capital		100,000	100,000	100,000	100,000
Current account		1,980,000	1,980,000	1,980,000	1,980,000
		<u>2,080,000</u>	<u>2,080,000</u>	<u>2,080,000</u>	<u>2,080,000</u>
Company E					
Share capital		250,000	250,000	250,000	250,000
Current account		8,850,000	8,850,000	8,850,000	8,850,000
		<u>9,100,000</u>	<u>9,100,000</u>	<u>9,100,000</u>	<u>9,100,000</u>
Company F					
Share capital		250,000	250,000	250,000	250,000
Current account		4,750,000	4,750,000	4,750,000	4,750,000
		<u>5,000,000</u>	<u>5,000,000</u>	<u>5,000,000</u>	<u>5,000,000</u>
Total interest	<u>2,908,296</u>	<u>19,088,296</u>	<u>19,088,296</u>	<u>16,180,000</u>	<u>16,180,000</u>
Current assets					
Loan to a shareholder	7,357,953	-	-	-	-
Other current assets	40,572	26,075	6,025	5,475	3,306
	<u>7,398,525</u>	<u>26,075</u>	<u>6,025</u>	<u>5,475</u>	<u>3,306</u>
Current liabilities					
Sundry creditors & accrued charges	9,607,100	9,808,220	10,234,120	10,859,187	10,360,786
Shareholder's loan	-	9,213,800	9,363,800	6,462,504	6,948,052
	<u>9,607,100</u>	<u>19,022,020</u>	<u>19,597,920</u>	<u>17,321,691</u>	<u>17,308,838</u>

	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
	\$	\$	\$	\$	\$
Interest in associated companies					
Company D					
Share capital	126,000	126,000	126,000	126,000	126,000
Current account	2,498,133	2,498,133	2,505,466	2,509,766	2,520,840
	<u>2,624,133</u>	<u>2,624,133</u>	<u>2,631,466</u>	<u>2,635,766</u>	<u>2,646,840</u>
Company E					
Share capital	220,000	220,000	220,000	220,000	220,000
Current account	7,796,333	7,796,333	7,804,667	7,804,667	9,064,723
	<u>8,016,333</u>	<u>8,016,333</u>	<u>8,024,667</u>	<u>8,024,667</u>	<u>9,284,723</u>
Company F					
Share capital	220,000	220,000	220,000	220,000	220,000
Current account	4,203,334	4,203,334	4,210,667	4,216,367	4,228,091
	<u>4,423,334</u>	<u>4,423,334</u>	<u>4,430,667</u>	<u>4,436,367</u>	<u>4,448,091</u>
Total interest	<u>15,063,800</u>	<u>15,063,800</u>	<u>15,086,800</u>	<u>15,096,800</u>	<u>16,379,654</u>

(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS

Current assets					
Sundry trade debtors	2,230,119	-	-	4,947,816	4,207,650
Other current assets	132,723	7,861	745	1,008,176	77,125
	<u>2,362,842</u>	<u>7,861</u>	<u>745</u>	<u>5,955,992</u>	<u>4,284,775</u>
Current liabilities					
Sundry creditors & accrued charges	10,773,853	11,355,253	9,643,120	8,240,000	7,810,000
Sundry trade creditors	2,130,119	-	-	4,440,868	4,127,574
Shareholder's loan	6,147,634	6,282,518	7,115,518	7,022,517	7,240,667
Sales deposits	110,500	-	-	998,750	-
	<u>19,162,106</u>	<u>17,637,771</u>	<u>16,758,638</u>	<u>20,702,135</u>	<u>19,178,241</u>

* interest bearing

28. The appellant declared the following assessable profits/adjusted loss in its profits tax computations:

	<u>1994/95</u>	<u>1995/96</u>	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>
	\$	\$	\$	\$	\$
Profit/(Loss) per accounts	(486,756)	(607,371)	(595,950)	(632,617)	10,684
Add: Adjusted items	416,964	4,475	-	3,005	-
Assessable profits/(Adjusted loss)	<u>(69,792)</u>	<u>(602,896)</u>	<u>(595,950)</u>	<u>(629,612)</u>	<u>10,684</u>
Less: Loss b/f set-off					(10,684)
Net assessable profits	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>
Loss b/f	-	69,792	672,688	1,268,638	1,898,250
Add: Loss for the year	69,792	602,896	595,950	629,612	-
Less: Loss set-off	-	-	-	-	(10,684)
Loss c/f	<u>69,792</u>	<u>672,688</u>	<u>1,268,638</u>	<u>1,898,250</u>	<u>1,887,566</u>

	<u>1999/2000</u>	<u>2000/01</u>	<u>2001/02</u>	<u>2002/03</u>	<u>2003/04</u>
	\$	\$	\$	\$	\$
Profit/(Loss) per accounts	(609,933)	(830,645)	895,016	1,201,751	1,135,530
Add: Adjusted items	956	-	-	-	-
Assessable profits/(Adjusted loss)	<u>(608,977)</u>	<u>(830,645)</u>	<u>895,016</u>	<u>1,201,751</u>	<u>1,135,530</u>
Less: Loss b/f set-off			(895,106)	(1,201,751)	(1,135,530)
Net assessable profits	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>
Loss b/f	1,887,566	2,496,543	3,327,188	2,432,172	1,230,421
Add: Loss for the year	608,977	830,645	-	-	-
Less: Loss set-off	-	-	(895,016)	(1,201,751)	(1,135,530)
Loss c/f	<u>2,496,543</u>	<u>3,327,188</u>	<u>2,432,172</u>	<u>1,230,421</u>	<u>94,891</u>

(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS

29. In arriving at the adjusted loss for the year of assessment 1994/95, the appellant has added back interest adjustment to reflect the portion of interest attributable to non-income producing assets. The disallowable portion was computed in the ratio of the shareholder's loan to total assets as follows:

$$\begin{aligned} & \$584,072 \text{ [Paragraph 26]} \times \{ \$7,357,953 / (\$2,908,296 + \$7,398,525) \} \\ & \text{[Paragraph 27]} = \$416,964 \end{aligned}$$

30. By letter dated 31 December 2003, Company G the appellant's auditors and former tax representatives, wrote on behalf of the appellant to the assessor asserting that:

- (a) Interest expenses were paid to Company B which had common shareholders and directors with the appellant at interest rates of 0.6% per month from 1 April 1997 to 28 February 1998, 1.0% per month from 1 March 1998 to 31 March 1998 and 0.8% per month from 1 April 1998 to 31 March 1999;
- (b) The loan was obtained and applied for use in the appellant's business activities in producing income chargeable to profits tax;
- (c) Company B was a financial institution which satisfied section 16(2)(a) of the Inland Revenue Ordinance; and
- (d) The sundry income of \$906,666 for the year ended 31 March 2002 was the interest payable to Company B for the period from 1 February 2000 to 31 March 2002 which was 'forgone by that Company' as the appellant was unable to repay the amounts owed to it.

31. In paragraph 1(10) of the Determination, the Acting Deputy Commissioner stated that the assessor was of the view that the loss sustained by the appellant for the years of assessment 1995/96 to 1997/98 should not be allowable for set-off against the profits for subsequent years since the appellant was not trading during these years and the assessor considered that adjustments should be made for the years of assessment 1998/99 to 2000/01 to disallow the interest expenses incurred by the appellant attributable to the financing of non-income producing assets by the following formula:

$$\text{Interest expenses} \times \frac{\text{total interest in associated companies} - \text{shareholder's loan}}{\text{total interest in associated companies} - \text{shareholder's loan} + \text{total current assets}}$$

32. In paragraph 1(11) of the Determination, the Acting Deputy Commissioner stated that the assessor issued to the appellant on 25 January 2005 the following profits tax assessments and statements of loss:

(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS

(a) Profits tax assessment 1998/99

\$

Profit per Paragraph 28	10,684
<u>Add: Interest disallowed [Note (i)]</u>	<u>778,387</u>
Assessable profits	789,071
<u>Less: Set-off of loss b/f from 1994/95 [Paragraph 28]</u>	<u>(69,792)</u>
Net assessable profits	<u>719,279</u>
Tax payable thereon	<u>115,084</u>

Note (i): $\$778,666$ [Paragraph 26] x $\{ \$ (16,180,000 - 6,948,052) /$
 $\$ (16,180,000 - 6,948,052 + 3,306) \}$ [Paragraph 27]

(b) Profits tax assessment 1999/2000

\$

Loss per Paragraph 28	(608,977)
<u>Add: Interest disallowed [Note (ii)]</u>	<u>617,230</u>
Assessable profits	<u>8,253</u>
Tax payable thereon	<u>1,320</u>

Note (ii): $\$780,800$ [Paragraph 26] x $\{ \$ (15,063,800 - 6,147,634) /$
 $\$ (15,063,800 - 6,147,634 + 2,362,842) \}$ [Paragraph 27]

(c) Statement of loss 2000/01

\$

Loss per Paragraph 28	(830,645)
<u>Add: Interest disallowed [Note (iii)]</u>	<u>777,970</u>
Loss for the year c/f	<u>(52,675)</u>

Note (iii): $\$778,666$ [Paragraph 26] x $\{ \$ (15,063,800 - 6,282,518) /$
 $\$ (15,063,800 - 6,282,518 + 7,861) \}$ [Paragraph 27]

(d) Statement of loss 2001/02

\$

Profit per Paragraph 28	895,016
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(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS

<u>Less:</u> Interest disallowed in 1999/2000 and 2000/01 forgone by Company B [Note (iv)]	<u>(879,155)</u>
Assessable profits	15,861
<u>Less:</u> Set-off of loss b/f [Paragraph 32(c)]	<u>(52,675)</u>
Loss c/f	<u>(36,814)</u>

Note (iv): $[(8,000,000 \times 0.8\% \times 2) \times 617,230 / 780,800] + \$777,970$
[Paragraph 32(c)]

(e) Profits tax assessment 2002/03

\$

Profit per Paragraph 28	1,201,751
<u>Less:</u> Set-off of loss b/f [Paragraph 32(d)]	<u>(36,814)</u>
Net assessable profits	<u>1,164,937</u>
Tax payable thereon	<u>186,389</u>

(f) Profits tax assessment 2003/04

\$

Assessable profits per Paragraph 28	<u>1,135,530</u>
Tax payable thereon	<u>198,717</u>

33. By letter dated 9 January 2007, the assessor wrote to J Enterprise Secretarial & Taxation Limited in respect of the 2004/05 year of assessment and the first paragraph reads as follows:

‘I refer to your letter dated 14 December 2006 and regret to advise that I cannot accept the above letter as a valid objection under section 64 of the Inland Revenue Ordinance. The notice of assessment and refund of tax for the year of assessment 2004/05 issued on 9 December 2006 is not an assessment because there is no tax payable by [the appellant]. [The appellant] may, however, lodge an objection when the claimed loss has not been carried forward and set off against any assessable profit subsequent to the year of assessment 2004/05 where there is final tax payable by [the appellant].’

34. By letter dated 11 January 2007, Ms A of J Enterprise Secretarial & Taxation Limited replied as follows:

‘We refer to your letter of 9 January 2007.’

2. We certainly understand what you said in your first paragraph. In principle, what you said is correct. However, please review your IRC 1902 issued on 8 December 2006. You have called it a Notice of Assessment for Year of Assessment 2004/05, thus inviting our objection.'

Deduction of interest expenses

35. Section 68(4) provides that the '*onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant*'.

36. Section 16(1), as it stood before the amendment in 2004, provided that:

'(1) 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-

(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, procurator fees, stamp duties and other expenses in connection with such borrowing; (Replaced 2 of 1971 s. 11. Amended 36 of 1984 s. 4)

...

(2) The conditions referred to in subsection (1)(a) are that-

(a) the money has been borrowed by (sic) a financial institution'.

37. We are puzzled by section 16(2). Should the condition be 'money borrowed from' or 'money lent by' a financial institution? As the provision now stands, this appeal must fail because the \$8,000,000 Company B loans were not 'borrowed by' a financial institution.

38. In addition to satisfying section 16(2), a taxpayer must also satisfy section 16(1) and is not caught by section 17(1) before loan interest may be deducted.

39. Section 17(1) provided that:

(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS

'(1) For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of- (Amended 36 of 1955 s. 25; 49 of 1956 s. 13)

...

(b) subject to section 16AA, any disbursements or expenses not being money expended for the purpose of producing such profits; (Amended 36 of 1955 s. 25; 31 of 1998 s. 11) [17 April 1998 version]

(b) any disbursements or expenses not being money expended for the purpose of producing such profits; (Amended 36 of 1955 s. 25) [30 June 1997 version]'.

40. Rule 2A(2) of the Inland Revenue Rules provides that:

'(2) Where, apart from or in addition to the circumstances referred to in paragraph (1) as giving rise to an apportionment, it is necessary to make an apportionment of any outgoing or expense by reason of it having been incurred not wholly and exclusively in the production of profits in respect of which a person is chargeable to tax under Part IV of the Ordinance, such apportionment or further apportionment, as the case may be, shall, subject to the provisions of rules 2B and 2C, be made on such basis as is most reasonable and appropriate in the circumstances of the case.'

41. In Zeta Estates Limited v Commissioner of Inland Revenue [2007] 2 HKLRD 102 at paragraphs 15, 16 and 25, Lord Scott formulated the question relevant to a taxpayer's tax liability and to the deductibility of the interest paid and underlined the importance of identifying 'the essential character of the expenditure' in order to determine 'whether it is in truth an outgoing incurred in gaining or producing the assessable income or necessarily incurred in carrying on a business having the purpose of gaining or producing assessable income':

'15 The question relevant to Zeta's tax liability and to the deductibility of the interest paid on the borrowings to raise the fresh working capital is why the capital was raised. If the fresh capital was raised by Zeta in order to retain, or maintain, its profit-earning assets the interest on the borrowings would, in my opinion, in principle be deductible under s.16(1)(a) whether or not the Commissioner or the Board, or anyone else, approves of the commercial judgment of the directors in deciding to raise the fresh working capital.

16. *Section 16(1)(a) refers to "... the purpose of producing ... profits". (Emphasis added.) However, the word "producing" should not, in my opinion, be given a restricted literal meaning. If the purpose of the borrowing is to maintain an existing profit producing capacity, the requirement of the statutory provision would, in my opinion, be satisfied.*

...

- 25 *The Australian statute, like Hong Kong's s.16, has no "wholly or exclusively ... for the purposes of trade ..." requirement. Under s.51(1) of Australia's Income Tax Assessment Act 1936 outgoings are deductible:*

... to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income ...

Commissioner of Taxation v Roberts and Commissioner of Taxation v Smith (1992) 23 ATR 494 were conjoined appeals raising the same issue. The taxpayers, Roberts and Smith, had been partners in a five-partner firm of solicitors that had borrowed \$125,000 from a bank and used the money to return \$25,000 to each partner so as to reduce the capital contribution required from prospective incoming partners. The issue was whether the interest on the loan was deductible under s.51(1). Taxpayer Smith had been a partner when the loan had been taken out. Taxpayer Roberts was an incoming partner who had joined the firm after the loan had been taken out. The Federal Court underlined the importance of identifying "the essential character of the expenditure" in order to determine "whether it is in truth an outgoing incurred in gaining or producing the assessable income or necessarily incurred in carrying on a business having the purpose of gaining or producing assessable income" (per Hill J at p.501). And at p.504 Hill J described the issue as being "whether the interest outgoing was incurred in the income producing activity or ... in the business activity which is directed towards the gaining or producing of assessable income." He said that "the characterisation of interest borrowed will generally be ascertained by reference to the objective circumstances of the use to which the borrowed funds were put ..." '

(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS

In paragraph 18, Lord Scott held that the purpose of the declaration of dividends in that case was too obvious to require to be supported by evidence and that the purpose of the loans was to fund the payment of the dividends was also as too obvious to require to be established by evidence. The four other judges in the Zeta case agreed with the judgment of Lord Scott.

42. The \$8,000,000 Company B loans were raised on 1 October 1993 when the appellant had ceased trading and was and remained dormant. The purpose of raising the loan was by no means apparent or obvious and should be established by evidence.

43. There is no evidence on *why* the \$8,000,000 Company B loans were raised.

44. There is no evidence on the extent, if at all, to which the interest expenses were incurred by the appellant in the production of profits in respect of which it was chargeable to profits tax for any period.

45. The appellant was dormant from 1995/96 to 1997/98.

46. We agree with the assessor and the Acting Deputy Commissioner that the appellant should not be allowed any deduction of outgoings and expenses for those years of assessment and no loss could be allowed and carried forward for set off against profits in any subsequent year.

47. For the years of assessment 1998/99 to 2000/01, the question is whether an apportionment of the interest expenses should be made to exclude the non-income producing component.

48. We are bound by authority to hold in favour of apportionment.

49. To start with, section 16(1) provides for the deduction of expenses ‘to the extent to which they are incurred’ in the production of profits.

50. In So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416, Chu J stated in paragraph 25 that:

‘25. *Although the words “wholly and exclusively” are no longer part of s.16(1), the section nevertheless entitles the Commissioner to ascertain the extent to which the expense is incurred in the production of chargeable profits. In the same vein, the Commissioner would have to ascertain whether the expense was incurred solely or partly for the production of profits. Common sense would dictate that once he concluded that the expense was not solely for the production of profits, he should go on to determine how much of it was incurred for the*

(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS

production of chargeable profits. These are common sense principles and do not depend on the interpretation of English legislation.'

51. Throughout the years of assessment 1994/95 to 2000/01, the appellant made various loans to its associated companies and a shareholder (in the 1994/95 year of assessment). The loans were interest free. See paragraph 27 on the amounts of interest in associated companies and the total current liabilities.

52. Rule 2 of the Inland Revenue Rules provides that apportionment is on the basis as is most reasonable and appropriate in the circumstances of the case. No attempt has been made to show how the apportionment by the Revenue is not reasonable or appropriate. The appellant has not discharged the onus of proving that any assessment appealed against is incorrect or excessive.

53. No interest expenses has been claimed in the 2001/02 – 2003/04 years of assessment.

Rule in Clayton's case (1816) 1 Mer 572

54. We have received no assistance whatever from the appellant or J Enterprise Secretarial & Taxation Limited on, how, if at all, any of the assessments appealed against is incorrect or excessive by applying the rule in Clayton's case. Neither the appellant nor J Enterprise Secretarial & Taxation Limited has performed a Clayton's case apportionment.

55. Assuming without deciding that the rule in Clayton's case is applicable in this case, the appellant has not discharged the onus of proving on a balance of probabilities that any of the assessments appealed against is incorrect or excessive.

The 2004/05 year of assessment

56. It is apparent from the letters referred to in paragraphs 33 and 34 above that the appellant claimed to have suffered a loss in the 2004/05 year of assessment.

57. In Commissioner of Inland Revenue v Malaysian Airline System Bhd [1992] 2 HKC 468 at page 469, Godfrey J stated that taxpayer had no right or need to challenge loss calculations made by the assessor.

58. By the letter dated 9 January 2007, the assessor explained why the appellant had no right to challenge the 2004/05 computation of loss. By letter dated 11 January 2007, J Enterprise Secretarial & Taxation Limited accepted the correctness in principle of what the assessor stated.

59. To take the matter to the Board simply because the assessor had called the document a Notice of Assessment is a waste of costs of the client of J Enterprise Secretarial & Taxation

(2007-08) VOLUME 22 INLAND REVENUE BOARD OF REVIEW DECISIONS

Limited, a waste of the Revenue's time and resources and an abuse of the appeal process to the Board of Review.

Outcome of appeal

60. For the reasons given, the appeal fails.

61. We dismiss the appeal and confirm the assessments as confirmed by the Acting Deputy Commissioner.

Costs order

62. We are of the opinion that this appeal is frivolous and vexatious and an abuse of the process. Pursuant to section 68(9) of the Ordinance, we order the appellant to pay the sum of \$5,000 as costs of the Board, which \$5,000 shall be added to the tax charged and recovered therewith.