

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D38/89

Profits tax – interest income – whether bad debts can be deducted from assessable profits.

Panel: T J Gregory (chairman), Philip Fu Yuen Ko and Albert Ho Chun Yan.

Date of hearing: 27 February 1989.

Date of decision: 22 August 1989.

The taxpayer was a member of a group of companies and lent money to other group companies. One of the other group companies to which it lent money was wound up and failed to repay the money which it had borrowed from the taxpayer. It was submitted that the taxpayer was carrying on the business of money lending and the bad debt should be allowed against its taxable profits. Alternatively if it was not a money lender then it had no assessable income other than interest which should be taxed as interest and not as profits.

Held:

The company was not a money lender and that all payments received by the taxpayer from the debtor company should be applied in payment of accrued interest and not repayment of capital.

Appeal dismissed.

Cases referred to:

Shun Lee Investment Co Ltd v CIR 1 HKTC 322

Lichfield v Dreyfus [1906] 1 KB 584

Commonwealth Tax Case and Board of Review No 3, 13 CTBRNS Case 35

Jennifer Chan for the Commissioner of Inland Revenue.

Kenneth Lo of Kenneth Lo & Co for the taxpayer.

Decision:

1. THE FACTS

The facts, which are not in dispute, are as follows:

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- 1.1 The Taxpayer was incorporated in Hong Kong pursuant to the Companies Ordinance in July 1971.
- 1.2 In the relevant year of assessment, 1984/85, the Taxpayer made interest bearing as well as interest free borrowings and loans from or to its affiliated companies. Factually, this had been its business for some years.
- 1.3 On 8 July 1985 a winding up order was made by the court against X Limited, an affiliated company, which had obtained interest bearing loans from the Taxpayer from as early as 16 November 1981 and as at 31 March in each of the undermentioned years the amounts of principal outstanding were as follows:

<u>Year</u>	<u>Outstanding Principal</u> \$
1982	8,255,888.51
1983	2,219,347.18
1984	1,880,247.30

- 1.4 The Taxpayer's accounts for the year ended 31 March 1985, filed in support of objections against an estimated assessment, reflected that its only source of income was interest income of \$8,087,111. Against this income the Taxpayer charged 'bad debts written off' of \$4,697,965 in the profit and loss account and claimed this amount as an allowable deduction in the proposed tax computations. In the supporting schedules accompanying the accounts the Taxpayer provided details of the bad debts written off as follows:

'Analysis of bad debts written off

X Limited (in creditor's winding up)	\$4,697,965'
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- 1.5 By letter dated 11 February 1987 addressed to the Revenue the Taxpayer provided a breakdown of the interest received, all of which came from four companies. One was X Limited which contributed \$540,485.59 of the total of \$8,087,110.96. All of these four companies had their registered offices in the same building as the Taxpayer. The letter also provided details as to the bad debts written off, namely the loan to X Limited, and confirmed there was no formal loan agreement or document evidencing the terms of the advance, that there had been no collateral, that all interest charged on the loan had already been included as assessable income in every relevant year of assessment and stating that the Taxpayer was a money lender licensed under the Money Lenders Ordinance.

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- 1.6 By letter dated 14 May 1987 the assessor requested the Taxpayer to provide further information which was not provided until the lodgement of the Taxpayer's grounds of appeal by letter dated 31 January 1989.

2. JURISDICTION OF THE BOARD

- 2.1 The Board queried whether an appeal against the assessment was the correct procedure or whether the Taxpayer should have applied under section 70A for the reopening of the assessment as the Taxpayer's representative stated in his letter of 31 January 1989, the determination of the Commissioner, and hence the assessment, was not wrong but would have been different had the Taxpayer responded promptly to the letter dated 14 May 1987 in which the assessor sought additional information.
- 2.2 The Revenue wished to proceed on the basis that, having considered the answers to the letter dated 14 May 1987 as contained in the Taxpayer's representative's letter of 31 January 1989, the assessment would not have been revised.
- 2.3 With respect to the Revenue, the Board does not really consider that to be the correct way to proceed. Nevertheless, the Board permitted the appeal to proceed at the request of the parties.

3. DOCUMENTATION

The Board had before it copies of the following documents:

- 3.1 Annual returns of X Limited for the years from 1981 to 1984, both inclusive.
- 3.2 The Taxpayer's statement of accounts for the year ended 31 March 1984.
- 3.3 An analysis of interest paid during the year ended 31 March 1984.
- 3.4 A schedule showing the amounts of principal and interest owed to the Taxpayer by X Limited from 16 November 1981 to 31 March 1985.
- 3.5 The Taxpayer's statement of accounts for the year ended 31 March 1985.
- 3.6 Application for business registration certificate by the Taxpayer dated 12 August 1975.
- 3.7 Profits tax return of the Taxpayer for the year of assessment 1975/76 dated 5 November 1975.

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- 3.8 Receipt from X Limited to the Taxpayer for \$7,834,590.90 dated 16 November 1981.
- 3.9 Schedule of interest receipts by the Taxpayer from X Limited for the year ended 31 March 1982 (undated).
- 3.10 Schedule of interest receipts by the Taxpayer from X Limited for the year ended 31 March 1983 (undated).
- 3.11 Schedule of interest receipts by the Taxpayer from X Limited for the year ended 31 March 1984 (undated).
- 3.12 Notice of application to Lands Tribunal with respect to a tenancy agreement for X Limited dated 18 February 1985.
- 3.13 Schedule of interest receipts by the Taxpayer from X Limited for the year ended 31 March 1985 (undated)
- 3.14 Final assessment for the year 1983/84 and provisional payment 1984/85 dated 3 April 1985.
- 3.15 Profits tax computation for the Taxpayer for the year of assessment 1984/85 with supporting schedules.
- 3.16 Statement of affairs of X Limited as of 8 July 1985 sworn on 8 July 1985.
- 3.17 The Taxpayer's statement of accounts for the year ended 31 March 1986.
- 3.18 Analysis of loss on assignment of debts for the year ended 31 March 1986.
- 3.19 Proposed profits tax computation from the Taxpayer for the 1985/86 year of assessment.
- 3.20 Letter dated 11 February 1987 from the Taxpayer for the 1985/86 year of assessment.
- 3.21 Determination of the Commissioner dated 31 March 1988 with annexed appendices.
- 3.22 Letter dated 12 April 1988 from the Taxpayer's representative to the Clerk of the Board of Review.
- 3.23 Letter dated 31 January 1989 from the Taxpayer's representatives containing the grounds of appeal.

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4. THE APPEAL

The Taxpayer did not adduce any evidence and a written submission was handed in by the representative. The submission was to the following effect:

- 4.1 The grounds of appeal are:
 - 4.1.1 that the assessment was excessive;
 - 4.1.2 that the assessor had not looked into the whole facts;
 - 4.1.3 that the loss, being a loss on money lending, was an allowable deduction under section 16(1)(d) of the Ordinance;
 - 4.1.4 that interest previously brought into account for tax purposes should be allowed as a deduction.
- 4.2 There had been a delay in answering the assessor's queries whereby it could not be said that the determination was wrong but if the full facts had been available the determination would have been different.
- 4.3 The Taxpayer had held a money-lender's licence for the twelve months from 1 February 1985 and that the description 'share investment' in the Taxpayer's profits tax return was a misnomer and that regard should be had to the form and substance as opposed to an unwitting misdescription.
- 4.4 That from the commencement of its business until 31 March 1985 the Taxpayer's income from interest on money-lending was detailed in paragraph 1c of the letter of 31 January 1989, document 3.23, and that during the three years from 1 April 1979 to 31 March 1982 the other small income consisted of dividends, the surplus on sale of quoted shares and minor sundry income only. The Taxpayer could not be regarded as having carried on any investment business. The document evidencing the loan, the receipt document 3.8, supported this.
- 4.5 The Taxpayer was not trading with X Limited other than lending money. The \$4,697,965 was a loan made by the Taxpayer in the normal course of its money-lending business and for no other purposes.
- 4.6 The case of Shun Lee Investment Co Ltd v CIR 1 HKTC 322 was superficially similar to that of the Taxpayer but there was a series of important distinctions which were identified. The Board's attention was also drawn to the opinion of the dissenting member. Reliance was also placed on an inference said to be capable of being drawn from the passage at pages 330 to 332 in which the

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Learned Trial Judge, Ridby J, placed much emphasis on the distinction between 'fixed capital' and 'circulating capital'.

- 4.7 The submission concluded that:
- 4.7.1 as the Taxpayer was carrying on the business of money lending the bad debt should be allowed; and
- 4.7.2 on the face of the audited accounts, there was no income which was chargeable to profits tax and that if, in the assessments, the Taxpayer was not to be treated as a money lender then the assessment under objection should be revised to nil and an interest tax assessment issued in lieu.

5. REVENUE'S SUBMISSION

- 5.1 The Revenue's submission was also in writing and was accompanied by the copies of the documents previously listed and which were not annexed to the Taxpayer's notice of appeal.
- 5.2 The Revenue drew the Board's attention to the fact that the details provided by the Taxpayer, through its representative, by appendix VI-(A) to (D) accompanying their letter dated 31 January 1989, revealed that other than the initial amount of \$7,834,590.90 lent on 16 November 1981 three further sums were lent to X Limited as follows:

<u>Date of Advance</u>	<u>Amount of Advance</u> \$
1-7-83	727.20
30-6-84	1,459,151.40
4-9-84	1,218,085.50

- 5.3 This information disclosed that interest was calculated and added to the total borrowing and that when repayments were received from X Limited such were deducted from the total outstanding. The Revenue was prepared to accept that the sum claimed to be deductible was made up of:

Principal	\$4,320,873
Interest	<u>377,092</u>
Total claimed	<u>\$4,697,965</u>

- 5.4 The calculation by the Revenue followed the principles of appropriation of payments set out in Chitty on Contracts, General Principles, twenty-third edition, at paragraphs 1171 to 1173 and 1178 and 1179. A computation

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submitted by the Revenue appropriating the repayments first to interest then to principal and to balances in chronological order supported the Revenue's calculations.

5.5 Deduction of bad debts:

5.5.1 Interest:

This is regulated by section 16(1)(d) of the Ordinance. The Revenue accepted that the interest accrued in the Taxpayer's accounts as it related to the advance for X Limited had been assessed to profits tax. However, the Revenue did not accept that interest since the inception of the loan, totalling \$1,799,657, and claimed by the Taxpayer should be deducted. There was no clear evidence that the repayments had all been applied to set off the principal lent. If the Board accepted the method of appropriation set out in Chitty, refer 5.4 above, and so apportioned the monies received from X Limited, then only \$377,092 would be allowable in accordance with the first limb of proviso (i) to section 16(1)(d).

5.5.2 Principal:

The second limb of proviso (i) to section 16(1)(d) restricts the deduction of the irrecoverable principal to persons carrying on a money lending business. Accordingly, in order to be successful in claiming the deduction of the principal amount of a loan the principal has to have been lent by a person who carries on a money lending business in the course of that business.

5.5.3 The Revenue proceeded to analyze a money lending business citing:

5.5.3.1 Lichfield v Dreyfus [1906] 1 KB 584 at page 589, namely 'speaking generally, a man who carries on a money lending business is one who is willing to lend to all and sundry provided they are, from his point of view, eligible.'

5.5.3.2 Shun Lee Investment Co Ltd v CIR 1 HKTC 322

5.5.3.3 The Australian Income Tax Act section 63(1)(b) being similar to section 16(1)(d) of the Ordinance.

5.5.3.4 Commonwealth Tax Case and Board of Review No 3, 13 CTBRNS case 35, a case in which a taxpayer company, registered as a money lender, engaged in making private loans to its associated companies and claimed deductions under section 63(1)(b) of the Australian Income Tax Act which in respect of one of the loans which became irrecoverable. The claim was disallowed by the Board as, on the evidence, the taxpayer did not come under the business of lending money.

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- 5.5.4 The Revenue submitted that on the relevant case law some of the indicia of a money lending business are:
- 5.5.4.1 That the person is willing to lend to all and sundry, provided they are from his point of view eligible;
 - 5.5.4.2 That there must be frequent turnover of the money in the course of the business – long period of time allowed for repayment is an indication of an investment business rather than a money lending business;
 - 5.5.4.3 That the money lender requires not only regular and frequent payments by way of interests on account of his numerous loans but also regular repayments on account of principal;
 - 5.5.4.4 That it is not sufficient to prove that money has been lent occasionally at a remunerative rate of interest: it is necessary to prove some degree of system and continuity in the money lending transactions and loans to something more than friends, relatives or associated companies;
 - 5.5.4.5 That in considering whether a person is carrying on a business of money lending all loans made must be taken into account;
 - 5.5.4.6 That interest is not, of itself, conclusive evidence of a money lending business being carried on, neither is the person nor the business being a money lender conclusive evidence.
- 5.5.5 The evidence provided by the Taxpayer to the assessor, no evidence having been adduced from the Taxpayer to the Board, as to the nature of the Taxpayer's business activities and how it conducted its business did not, in the Revenue's submission, establish that the Taxpayer was carrying on a money lender's business. From the accounts and correspondence presented to the Revenue by the Taxpayer it was apparent that:
- 5.5.5.1 The Taxpayer is a private company with an issued share capital of \$300,000 founded by an individual in 1958 who continued to the date of the appeal as a shareholder;
 - 5.5.5.2 The business was managed by a son of the founder and family members of the founder or that son;
 - 5.5.5.3 The Taxpayer was able to obtain funds from affiliated companies either interest free or at very favourable rates of interest;
 - 5.5.5.4 In the three years of assessment 1983/84 to 1985/86 the Taxpayer granted loans and advances in the following amounts:

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1983/84	\$415,000,000
1984/85	\$400,045,000
1985/86	\$296,000,000

5.5.5.5 The majority of those loans and advances were to affiliated companies, the term used in the balance sheet, namely:

1983/84	\$335,000,000
1984/85	\$331,000,000
1985/86	\$219,000,000

5.5.5.6 The great majority of the advances to the affiliated companies did not have a fixed term of repayment and were non-interest bearing, established by the fact that the amount owing from some of these companies remained the same throughout the years 1983 to 1986 various examples of which were identified in the documentation.

5.5.5.7 Loans were also made to a director and an officer of the Taxpayer which were unsecured, free of interest and without a fixed term for repayment.

5.5.5.8 The beneficiaries of the loans had some connection with the directors of the Taxpayer.

5.5.5.9 The Taxpayer's balance sheet shows the balances were due from 'debtors' but there is no information of the nature of the transaction with these debtors and the auditor made significant qualifications with regard to such balances.

5.5.5.10 In the year ended 31 March 1985 the Taxpayer agreed to take up shares in a debtor in satisfaction of the amount due from that company.

5.5.5.11 With regard to the loan to X Limited it was unsecured and there was no fixed term for repayment. Although interest was calculated on the sum lent there was no arrangement for regular payment of interest.

5.5.5.12 X Limited showed the same business address as the Taxpayer and according to the annual returns filed by X Limited it was a company managed by members of the same family as the Taxpayer.

5.5.5.13 In the year of assessment 1985/86 the Taxpayer wrote off as bad debts large balances due from other affiliated companies.

5.5.6 The Revenue submitted that this cumulative evidence supported their contention that the Taxpayer was not 'willing to lend to all and sundry' but only to related companies and that those transactions could hardly be labelled as

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business transactions. As many loans to related companies were non-interest bearing there was no profit motive and that for the few loans which were interest bearing there was no evidence that the Taxpayer made any effort to ensure the payment of interest.

5.5.7 There was no evidence of the Taxpayer taking action for payment of the debts and in the case of one default shares were accepted and, in the instance of the X Limited loan, the Taxpayer was prepared to write off the debt without taking action to enforce repayment.

5.5.8 The Revenue then made comments on the Taxpayer's grounds of appeal.

5.5.9 The Commissioner's representative concluded by saying that the Taxpayer had failed to establish that it carried on a bona fide money lending business. The amount so far as it related to principal should not be allowed as a deduction as a bad debt under section 16(1)(d) of the Ordinance.

5.6 The Taxpayer's reply

5.6.1 In the Taxpayer's reply to the Revenue's submission the Taxpayer's representative stated that the Taxpayer was in the course of business of borrowing money from affiliates whilst it was not needed and channelled this money to other companies. Not all of the borrowers were wholly owned or controlled and such borrowers would be charged an interest. Some of the borrowings were made free of interest and, accordingly, were lent free of interest. Other of the borrowings were interest bearing and, accordingly, were loaned at interest.

5.6.2 The representative referred to paragraphs (E) and (F) of his letter of 31 January 1989, document 5.23, and stated that some of the Taxpayer's business was money lending but not all of it. This page also provided details of the interest income and expenditure.

5.6.3 The Taxpayer's representative also disagreed with the appropriation principles which the Revenue had cited from Chitty but did not give any reasons to support that disagreement.

6. REASONS FOR THE DECISION

6.1 Title headings and descriptions:

The Board agrees with both parties: misdescriptions are not conclusive and it is necessary to look to the substance of the transactions to determine precisely what the transactions were. In reaching its decision the Board has adopted this approach.

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6.2 The Taxpayer's business:

6.2.1 It is clear that the Taxpayer operated a variation of what is frequently described as a 'treasury system': those member companies of a group with surplus funds lend these surplus funds to another particular member of the group which then channels those funds to the member companies in need of funds whereby the group reduces its need to borrow from banks and, under normal circumstances, the interest which would otherwise be payable to a bank is retained within the group by being paid by the borrower to the internal 'finance company' and then paid by the internal 'finance company' to the member which has loaned the monies. The variation: if interest was not incurred by a borrowing no interest was charged on the on-lending.

6.2.2 It is pertinent to comment that the audited accounts of the Taxpayer at 31 March 1985 show a paid up capital of \$300,000, investments of \$37,610,046, namely quoted shares issued by a related company in satisfaction of a debt of the same amount, fixed assets of \$164, that is the depreciated book value of furniture and fixtures, unsecured borrowings of \$433,417,324 and amounts due from affiliated companies of \$322,307,775. These accounts are heavily qualified by the auditors, which qualification includes the following paragraph:

'The ability of (the Taxpayer) to carry on business as a going concern depends on the assumption that the loans and deposits placed with (the Taxpayer) by the affiliated companies will not be withdrawn in the foreseeable future.'

The Taxpayer's reference to the Shun Lee Investment Co Ltd case appears totally misconceived.

6.2.3 In the Taxpayer's financial year ended 31 March 1985 its balance sheet shows as current liabilities 'loans and deposits – unsecured' of \$433,417,324 and as current assets \$426,853,273 of which \$322,307,775 is described as 'amounts due by affiliated companies'. The profit and loss account shows interest received of \$8,087,111 and interest paid of \$4,926,713. Mathematically interest payments are about 1.5% of the borrowings and Interest receipts are about 2.51% of the amounts due from (or by) affiliated companies.

6.3 Money lender's licence:

The carrying on of the business of money lending is a question of fact. The holding a money lender's licence is irrelevant to whether or not a money lending business is or is not being conducted. It is necessary to see what the evidence establishes.

6.4 Money lender's business:

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6.4.1 The Board accepts the indicia of a money lending business submitted by the Revenue, refer paragraph 5.5.4 above. On the evidence before the Board is satisfied that the business of the Taxpayer was not a money lending business as those words are normally interpreted, refer Lichfield v Dreyfus and the indicia summarised in paragraph 5.5.4 above. Support for this view is obtained from the documentation produced to the Board: the vast majority of the loans were lent to companies associated with the controlling shareholders of the Taxpayer and it is reasonable to infer from the documentation that borrowings from companies wholly owned by the same shareholders as the Taxpayer were borrowed free of interest and so on-lent to other companies wholly owned by the Taxpayer and that it was only in instances in which there were third party shareholders that funds borrowed by the Taxpayer were borrowed at interest and on-lent at interest.

6.4.2 Further, the fact that one irrecoverable loan was converted into shares and that the debt of X Limited was not pursued is indicative of the type of operation of the Taxpayer. The information ultimately provided by the Taxpayer's representative under their letter of 31 January 1989 with respect to this loan was that the statement of the affairs shows a deficit of \$31,451,024.30 whereby legal fees were not deemed justified. It is noted that the document in support of this loan is a receipt reading as follows:

‘Received from [Taxpayer] the sum of \$7,834,590.90 being a clean loan advanced to us payable on demand at the annual interest rate of 2% above the prime rate.’

The Board is satisfied that the Taxpayer was not carrying on business as a money lender.

6.5 Appropriation:

The Board accepts the Revenue's submission as to the appropriation of repayments, refer paragraph 5.4 above. In the absence of any direction from X Limited when a repayment was made, or specific appropriation by the Taxpayer on receipt of a repayment, the Board accepts repayments should be deemed applied to discharge accrued interest with the balance, if any, then applied in reduction of the outstanding principal.

6.6 Deductibility of unrecovered interest:

The Board accepts the Revenue's submission that under the first part of the proviso to section 16(1)(d)(i), and applying the principles of appropriation previously referred to, all repayments from X Limited should be applied to offsetting accrued interest whereby the amount to be allowed should be limited

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to the difference between interest accrued and recovered from the repayments, creating an allowable deduction of \$377,092.

7. DETERMINATION

For the reasons given, the appeal fails but the Board remits the assessment to the Revenue for the allowance of the \$377,092 in accordance with the first limb of proviso (i) to section 16(1)(d).