

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D41/88

Interest tax – exemption for interest paid to company carrying on business – acts preparatory to opening restaurant – whether taxpayer was carrying on business – s 28(1), proviso (b) of the Inland Revenue Ordinance.

Panel: Denis Chang QC (chairman), Chiu Chun Bong and Christopher Chan Cheuk.

Dates of hearing: 28 and 29 March, 20 and 21 April 1988.

Date of decision: 14 October 1988.

The taxpayer company earned interest on certain bank deposits which it held while establishing premises for its restaurant business. It claimed that during this preparatory phase it was carrying on business and was therefore not subject to interest tax. The IRD claimed that the taxpayer did not commence carrying on business until the restaurant actually opened, in which case its interest income was subject to interest tax.

During the preparatory period, the taxpayer raised capital and loans, invested funds on bank deposits, acquired a business name and goodwill of another business, incurred professional fees, leased and outfitted premises, purchased fittings and supplies, sourced food products and rented office space and staff quarters.

The taxpayer had been established for the purpose of acquiring an existing business operated by a related company, and a sense of continuity characterized the activities of the taxpayer during this period.

The taxpayer's profits tax returns and directors' reports prepared during the preparatory period stated that the taxpayer had not yet commenced business.

Held:

- (a) The company was carrying on business during this preparatory period, and the interest was exempt from interest tax.
- (b) The taxpayer's activities were targeted towards the specific purpose for which the company was formed. This was unlike the case of a company which earns passive interest from bank deposits without intending to engage in any business activity. The investments were more than just remotely connected with the taxpayer's objects as set out in its memorandum of association.

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- (c) The taxpayer commenced business when it paid its rental deposit. The declarations by the taxpayer's directors that business had not commenced did not reflect the true position.

Appeal allowed.

Cases referred to:

Birmingham & District Cattle By-Products Co Ltd v CIR (1919) 12 TC 92
IRC v Korean Syndicate Ltd [1921] 3 KB 258
Softwood Pulp & Paper Ltd v FCT (1976) 76 ATC 4439

Jennifer Chan for the Commissioner of Inland Revenue.

Gladys Li instructed by Robert W H Wang & Co for the taxpayer.

Decision:

The Taxpayer was incorporated as a limited company in 1979. Its restaurant opened its doors for business in January 1983. Prior thereto, the company had incurred expenditure on various items and had received income by way of interest on deposits placed with a financial company.

The question for decision is whether or not the company was 'carrying on a trade or business in Hong Kong' at the time when the interest was earned and/or paid. If the answer is no, then the company has been correctly charged to interest tax for the year of assessment 1981/82. If the answer is yes, then it has been wrongly assessed since the interest would be exempt from interest tax under proviso (b) to section 28(1) of the Ordinance. The income received would simply be included in the relevant profits tax assessment.

The Revenue contends that the interest was earned and/or paid at a time when the company was merely doing acts preparatory to the commencement of business or, alternatively, that the Taxpayer has not discharged its burden of showing that it was actually carrying on a trade or business at the relevant time. The Commissioner determined that the date of commencement of business was January 1983, the date when the restaurant physically opened its doors for business.

It is agreed between the Revenue and the Taxpayer that activities of the company from the date of incorporation until 1 February 1982 included the following:

1. Raising of capital by way of directors' loans and issue of shares for the purposes of the company's business as evidenced by, among other things, board

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resolutions dated 12 August 1980, 27 August 1980, 8 September 1980, 6 October 1980, 14 August 1981 and 16 October 1981.

2. Investing of funds on time-deposit, withdrawals, renewals, etc between 10 August 1981 and 1 February 1982.
3. Acquiring a trade-name and performing such acts as were necessary to secure and register the right to use the name, as evidenced by the expenditure on legal and professional fees set out in the profits tax computation for the years of assessment 1979/80 and 1980/81 and further by entries in the taxpayer's books (among others) on 28 August 1980, 1 September 1980 and 28 October 1980.
4. Acquiring the goodwill of an existing business, payment being made on 28 August 1980.
5. Locating premises suitable for the restaurant, offering to rent premises in West Kowloon for the restaurant and paying a rental deposit (April 1980 to July 1980), as evidenced by documents.
6. Engaging and conferring with design consultants/architects over restaurant decoration and fitting out, as inferred from expenditure on design fees during this period and as evidenced by, among other things, profits tax computations (leasehold improvements item) for years of assessment 1979/80, 1980/81 and 1981/82: entries in the company's books, for example, 10 October 1980, 25 November 1980, 10 December 1980, 2 February 1981, 23 February 1981, 25 February 1981; and travelling expenses, as set out in profits tax computations for years of assessment 1970/80 and 1980/81.
7. Purchasing chinaware, silverware, glassware etc for the restaurant as evidenced by board resolution on 13 October 1981.
8. Locating sources for meat supplies and suitable managerial staff in the United States, as evidenced by travelling expenses detailed in the profits tax computations for the years of assessment 1979/80, 1980/81 and 1981/82.
9. Purchasing furnishings and fittings for decoration of the restaurant, as evidenced by expenditure on wall paper, carpet and light fittings included in the profits tax computation for 1981/82.
10. Renting office premises and purchasing office equipment.
11. Renting residential premises and purchasing furnishings and fittings, and decorating premises for directors and the manager of the restaurant, as evidenced by, among other things, profits tax computations for 1981/82 (leasehold improvements).

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The evidence adduced before us included the viva voce evidence given by Mr A, the current managing director and a shareholder of the company, and by Mr B, a director and shareholder of the company. Mr B supplemented evidence contained in an affidavit of his (which was put before the Board at its first sitting in support of an application for adjournment at a time when he was on a trip abroad). The company also called Mr C, an executive director and chief manager of a bank. Mr C, we find as a fact, knew the former managing director of the company, Mr D, who, together with various companies of his, were customers of the bank. We also find, as facts, that one of those companies was Y Company which used to run a restaurant by the name of X Company in East Kowloon but which was later, in February 1979, voluntarily wound up; that it was from Y Company with the approval of other interested parties) that Mrs D prior to the company's incorporation purchased the goodwill and trade name of X Company; and that it was from her that the company after incorporation acquired the same. Mr D died on 12 January 1983. Mr Howard Finger, solicitor, was called by the company to give evidence in relation to documentation obtained from other sources concerning the assignment of the goodwill and use of the trade name.

The evidence shows, and we find as facts, that Y Company ceased operating the restaurant in East Kowloon when the lease ran out in the latter part of 1978 and the new rental demanded by the landlord was so high as to make it uneconomical to continue. Mr D wanted to and did succeed in getting in capital by way of directors' loans and subscriptions for the new corporate vehicle bearing the name of X Company which he created in October 1979 (that is, the company). The principal place of business for the company (prior to the renting of space in West Kowloon) was given in the business registration application as East Kowloon, although the company never actually operated a restaurant there. It was necessary for the goodwill and trade name to be acquired, and it was understandable why Mr D wanted to create a sense of continuity with the restaurant formerly operated by Y Company. The value of the goodwill and trade name lay substantially in this appearance of continuity which enabled the company subsequently to announce by advertisement that the restaurant was 're-opening' in West Kowloon.

Whilst the business which came to be carried on by the company-was of course not that of Y Company which had been wound up, the desire to maintain this sense of continuity characterised the activities of Mr D and of the company. This is not a case where the acts of the company were only directed at ascertaining whether it was feasible to carry on a particular line of business as was the position in the case cited to us of Softwood Pulp & Paper Ltd v FCT (1976) 76 ATC 4439. Monhennit J said: 'Everything that was done in this case, up till this time when the project ceased, was in any view entirely preliminary and directed to deciding whether or not an undertaking would be established to produce assessable income'.

In the present case, we find as a fact that everything was originally geared to a much earlier date of completion of the building in which the rented premises (of some 7,600 square feet) were situated. The premises were originally expected to be ready for occupation

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towards the end of 1980 or early 1981. However, there were delays in the construction of the building on the part of the landlord, and it was not until October 1982 that possession of the premises was given.

We find as a fact that, in the meantime, the company had already raised at least part, and had already found the means of raising all, the funds necessary to meet both actual and anticipated needs and, insofar as the funds raised were not immediately required, they were invested by way of interest-bearing deposit account. This was doing something which was perfectly natural and within the objects of the company. The objects clause in the memorandum and articles of association of the company included the carrying on of a restaurant business, the acquiring of the goodwill of any business as well as 'to invest and deal with the moneys of the company not immediately required for the purpose of its business in ... such manner as may from time to time be considered expedient' (clause 3(3)).

There were three deposits:

- (i) \$100,000 was deposited on 10 August 1981 and withdrawn on 15 August 1981. It was a 24-hour call deposit for a period of five days.
- (ii) \$250,000 was deposited on 30 September 1981 and withdrawn on 26 October 1981. It was again a 24-hour call deposit.
- (iii) \$600,000 was deposited on 29 September 1981 on time deposit. On maturity date on 29 October 1981, it was put on 24-hour call deposit. \$108,506.52 was withdrawn on 20 November 1981 and another \$100,000 was withdrawn on 4 January 1982, leaving \$400,000 at the close of the accounting year.

A full table of the deposits and interest earned is set out herein below:

Detail breakdown re : interest income for the year ended 31 January 1982

<u>Principal</u> \$	<u>Period</u>	<u>Day</u>	<u>Interest</u> <u>Rate</u>	<u>Gross</u> <u>Interest</u> \$
100,000.00	10-8-81 – 14-8-81	4	16-1/2	180.82
100,000.00	14-8-81 – 15-8-81	1	16	43.84
250,000.00	30-9-81 – 5-10-81	5	16-1/2	556.51
250,000.00	5-10-81 – 9-10-81	4	16-3/8	448.63
250,000.00	9-10-81 – 20-10-81	11	16	1,205.48
250,000.00	20-10-81 – 26-10-81	6	16-1/4	667.81
600,000.00	29-9-81 – 29-10-81	30	17-1/4	8,506.85
608,506.85	29-10-81 – 31-10-81	2	17	566.83
608,506.85	31-10-81 – 16-11-81	16	16-1/4	4,334.57

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608,506.85	16-11-81 – 17-11-81	1	16	266.74
608,506.85	17-11-81 – 18-11-81	1	15-1/4	254.24
608,506.85	18-11-81 – 20-11-81	2	15	500.14
500,000.00	20-11-81 – 21-12-81	31	16	6,794.52
506,794.52	21-12-81 – 4-1-82	14	12	2,332.64
400,000.00	4-1-82 – 12-1-82	8	12	1,052.05
400,000.00	12-1-82 – 13-1-82	1	12-1/4	134.25
400,000.00	13-1-82 – 14-1-82	1	13	142.47
400,000.00	14-1-82 – 22-1-82	8	13-1/4	1,161.64
400,000.00	22-1-82 – 1-2-82	10	14-1/2	<u>1,589.04</u>
				<u>\$30,739.07</u>

By the time of the first deposit of money, the company had already held its first annual general meeting (which it did on 29 April 1981), resolved to capitalise various loans made to the company and, more than a year previously (on 3 July 1980), paid a deposit for renting the restaurant premises in West Kowloon. On 14 August 1981, the Board resolved to call an extraordinary general meeting for increasing the authorised capital of the company from \$2,030,000 to \$3,030,000. The authorised capital was so increased in September 1981.

It is also a fact that, by the time of the first deposit, the company had already paid, among other things, for the acquisition of the goodwill of the business and fees in connection with the X Company trade name.

We find that during the whole period in which the interest was earned on the moneys on deposit the company was, for present purposes, carrying on business in Hong Kong.

It matters not whether this business is characterised as an investment business as mandated by clause 3(3) of the objects clause or as something which is collateral or incidental to, or as something which is part of, the restaurant business.

We prefer, however, to base our decision on the continuum of activity which this company was engaged in, activity which was targeted towards and which was essential for the carrying out of those specific purposes within the objects clause for which the company was formed and which it had clearly resolved to and did pursue as its business. Where a continuum of this kind of activity is established, a company is prima facie carrying on business. Such activity, as we have found, included the acquisition of the necessary goodwill and trade-name and the renting of the premises, etc which enabled the company among other things to maintain an appearance of continuity between the X Company operated in East Kowloon and the X Company which opened in West Kowloon. This activity would have borne fruit by way of income from the restaurant much earlier had it not been for the delay in construction of the premises. In our view, it was activity which

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constituted the carrying on of business by the company despite the fact that the restaurant had not opened and the company was not in a position to earn income therefrom.

This is not to be equated with the case of an individual who does nothing but earns interest on money deposited with his bank, or with a company which instead of actively pursuing the purposes for which it was formed chooses to be nothing more than a passive recipient of interest on money left on deposit with no definite plan to engage in any other activity in furtherance of its objects.

In this connection we find the general approach adopted by the Court of Appeal in IRC v Korean Syndicate Ltd [1921] 3 KB 258 helpful. Lord Sterndale said at p 220: 'Now what is the business referred to in the memorandum and in the articles? It seems to me that it is the business of doing what is necessary to carry out the objects which the Syndicate elects to carry out.' At p 272 he said: 'That is not in any way like the case of a person who holds certain investments and merely draws the interest from them, or of an owner of mines who simply leases them in consideration of the payment to him of royalties. It is nothing in the least like either of those cases, but it is a carrying out of that object mentioned in the memorandum and which the Syndicate hopes to attain ..'.

We think the context makes it clear that Lord Sterndale (with whom Atkin LJ and Younger LJ agreed) was not saying that, if the company was doing anything which was remotely connected with any of the objects however minor expressed in the objects clause, then it must in every case be carrying on business. As Lord Sterndale puts it at p 273, the purpose for which the company comes into existence 'is a matter to be considered' when it comes to deciding whether what it does is carrying on a business or not. On the facts of that case there might, for example, have been a significant distinction between the interest earned on the money put on deposit and the royalties earned in turning the mining concession to account (see p 274).

We respectfully decline to follow the approach of Rowlatt J in Birmingham & District Cattle By-Products Co Ltd v the Commissioner of Inland Revenue (1919) 12 TC 92. He held that the company concerned did not commence its business until the company had got everything ready and had begun to take in the raw materials for turning out its product.

Although it is not strictly necessary for our decision, we have come to the view on the facts of the present case that the company had begun to carry on business by 3 July 1980 when it paid the deposit for the restaurant premises. We have taken into account Mr D's own declaration in September 1980 in the profits tax return ('business not commenced') and the directors' reports for the period ended 31 January 1981 and for the year ended 31 January 1982 where the principal activities stated were 'doing preparation for the opening of the restaurant'. We think that these statements can be explained by reference to Mr D's own understanding of the position arising from the fact that the restaurant had indeed not yet physically opened. They do not answer the mixed question of law and fact which we have to answer in this appeal.

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We allow the appeal accordingly and annul the relevant assessments.