

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D44/87

Board of Review:

Henry Litton, *Chairman*, Della P. H. Chan and Charles Yeung Siu-cho, *Members*.

22 October 1987.

Profits Tax—whether “loss on exchange” and “loss on disposal of landed properties” allowable deductions.

The Appellant company’s business for the period 1980 to 1983 was property dealing and money lending. The source of funds for the money lending business was derived partly from an associated company based in Singapore and partly from banks in Hong Kong. The profit margin derived by the Appellant company was in differential in interest rates charged, the Appellant company lending at higher rates of interest than the rates at which it borrowed. The Appellant company and the borrowers had strong connections. The major shareholder in all those companies was the same person. The Appellant company lent to no one except the affiliated companies. The Appellant company was used as a conduit pipe to fund the business of the affiliated companies. The Appellant contended that the exchange loss from Singapore dollars to Hong Kong dollars as at 31 March 1983 together with the outstanding interest were deductible from the assessable profits.

In August 1980 the Appellant company purchased a number of shop units. They were let to tenants and rental income was derived. For the year ending 31 March 1981 it was reflected in the accounts as fixed assets and in two subsequent years this position was maintained. In the year ending 31 March 1983 the Appellant company disposed of a number of units and in that process incurred a loss. The Appellant company contended that the loss was deductible against the chargeable profits.

Held:

The loss incurred on the difference in exchange rates between the Hong Kong dollar and Singapore dollar as at 31 March 1983 was not a loss incurred in the carrying on of the Appellant company’s business, but merely a charge in the accounts reflecting the difference between the rate of exchange at the time when the funds were borrowed and the 31 March 1983 when the line was drawn on the Appellant company’s accounts. The loss on sale of the landed properties was a capital loss and was not therefore deductible against the chargeable profits.

Appeal dismissed.

Pauline Fan for the Commissioner of Inland Revenue.

Jenny C. O. Lee of Messrs. Woo Kwan Lee & Lo Solicitors for the Appellant.

Reasons:

Introduction

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1. This appeal is concerned with the affairs of S Limited (the Company) for the year ending 31 March 1983.
2. In the Profits Tax Return for the year of assessment 1982/83 lodged by the company, a loss in the sum of \$1,144,072 was shown. In the computation of this loss, there was a figure of \$7,364,252 shown in the accounts as “loss on exchange”. In response to the assessor’s enquiries concerning this figure, the company’s representatives stated that this sum represented an exchange loss, from Singapore dollars to Hong Kong dollars as at 31 March 1983, on sums borrowed from S (Pte) Ltd (a Singapore company), together with interest outstanding as at that date.
3. The assessor did not accept the deduction of exchange loss from the assessable profits, and made adjustments accordingly in his assessment.
4. The company objected to the assessment. In the course of ascertaining the facts for the purposes of the Commissioner’s determination, further matters concerning the company were revealed. In his determination, the Commissioner:—
 - (i) confirmed the assessor’s disallowance of the exchange loss (together with a consequential interest adjustment), and
 - (ii) disallowed a further sum of \$1,323,946 by way of loss on sale of landed properties and adjusted the assessment accordingly.
5. Thus, on the appeal before us, two points arise:—
 - (a) whether the disallowance of the exchange loss (and the consequential interest adjustment) was correct, and
 - (b) whether the Commissioner’s disallowance of the loss on disposal of landed properties was correct.

Exchange loss

6. The company was incorporated in Hong Kong on 10 October 1969. Prior to August 1979, the company’s principal activities were related to the shipping business. However, in the two years prior to the year of assessment in question, the nature of the company’s business, as declared in the company’s Profit Tax Returns, was “Property Investment”.
7. From about July 1980, the company started to make substantial advances to affiliated companies, with the result that for the three years ending 31 March 1981, 1982 and 1983 the position as regards these advances was as follows:—

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	<i>Amount due from affiliated companies</i>
As at 31 March 1981	\$40,406,086
As at 31 March 1982	\$88,385,038
As at 31 March 1983	\$54,117,811

8. At the hearing before us, a Miss L, a Director of the company in charge of administration, accounting and finance, was called as a witness in support of the appeal. She had been with the company since its inception in 1969. She described the company's business for the period 1980 to 1983 as "property dealing and money lending".

She said that as far as the "money lending business" was concerned, the source of funds was partly from S (Pte) Ltd of Singapore, partly from banks in Hong Kong and partly from one of the Directors. She said that the profit margin derived by the company was in the differential in interest rates charged; the company lending at higher rates of interest than the rates at which it borrowed. She said that the interest rate charged by the Singapore company was 4% less than "the Hong Kong rate".

Miss L claimed in her evidence in chief that the "money lending business" of the company came about because the borrowers were various companies which they (the Company) knew well. She said they were "very familiar with the structure of those companies" and knew "the nature of their business". These were associated companies, she said.

9. When asked in cross examination how the company came to the decision to carry on a money lending business, and what steps were taken to solicit business, Miss L answered:—

"at that time the situation was that the property market was good. These companies (meaning the borrowers) had good plans, and they wanted to borrow from us. We had good relations with the Singapore company. We thought we could make a profit".

When asked whether the borrowing companies approached the appellant company, or the other way round, she answered:—

"the approached our company; we could obtain loans at lower rates".

10. Insofar as Miss L sought to convey in her testimony before us that these transactions were at arms-length, conducted in the course of a normal money-lending business, such impression is totally false.

11. The truth of the matter, as it emerged from the documentary evidence placed before us, and from Miss L's cross examination, is as follows:—

- (i) The major shareholders in the appellant company, in the Singapore lender S (Pte) Ltd and in each of the borrowers were Mr. T and the members of his family.

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- (ii) The company lent to no-one except these affiliated companies.
- (iii) There was no “soliciting” of business in any real sense; no bargaining, no agreement. Apart from entries in the company’s ledgers, not a scrap of documentary evidence has been adduced to support any of these “loans”.
- (iv) None of the borrowing companies had an issued capital exceeding \$1,000, and yet the advances were made without any form of security.
- (v) There was no fixed period for repayment.

On a closer examination of these advances, it was shown that in relation to two of them, the loans were recorded in the ledgers as having been made some months before the companies were incorporated. Eventually, the advances to the affiliated companies were written off during the year ending 31 March 1984.

12. In our judgment, the company’s attempt to suggest that, during the period in question, it was carrying on a “money lending business” and that the loss on exchange was incurred in the course of that business wholly fails. From beginning to end, the company was used as a conduit pipe to fund the business of the affiliated companies. With the funds borrowed, the affiliated companies bought a number of residential units in The Provident Centre at North Point. The affiliated companies were charged, in their books, a rate of interest higher than the rate at which the appellant company borrowed. These were merely book transactions, and did not reflect any prior commercial agreement between the parties.

13. The “loss” incurred on the difference in exchange rates between the Hong Kong dollar and the Singapore dollar as at 31 March 1983 was not a loss incurred in the carrying on of the company’s business. Not a scrap of evidence has been put before us as regards the nature of the company’s obligation owed to the Singapore company. The “loss” was merely a charge in the accounts, reflecting the difference between the rate of exchange at the time when the funds were borrowed and the 31 March 1983 when the line was drawn on the company’s accounts.

14. Insofar as it is appropriate to refer to the sums borrowed from the Singapore company (and the sums advanced to the borrowers) as being on revenue account or on capital account, then plainly the sums are on capital account. They were borrowed to fund the business of the affiliated companies, thereby swelling the loan capital of the affiliated companies to enable them to make the acquisitions of residential units in The Provident Centre.

Loss on sale of landed properties

15. In August 1980, the company purchased a number of shop units in the Kwan Yick Building in the Western District of Hong Kong. No resolution of the Directors has been put before us in evidence as regards the intention of the company at the time of acquisition.

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16. The shop units, at the time of acquisition, were let to tenants and, in the three years ending 31 March 1981, 1982 and 1983 the rental income derived from the properties was as follows:—

<i>Rental Income</i>	<i>1981</i>	<i>1982</i>	<i>1983</i>
	332,086	584,700	611,350

Upon acquisition, the properties went into the accounts of the company for the year ending 31 March 1981 as “fixed assets”. The nature of business of the company, as declared for that year, was “property investment” and depreciation was charged at 2% per annum.

In the tax computations for all three years (1981, 1982 and 1983) re-building allowances were claimed in respect of the shop units at Kwan Yick Building.

17. In the year ending 31 March 1983, the company disposed of a number of shop units at Kwan Yick Building, and the amount was reflected in the Profit and Loss Account under the heading of “Extraordinary Items” as follows:—

Disposal of Fixed Assets	(1,323,946)
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18. In the light of the facts as set out above, we cannot see how the Commissioner could have come to any other view than that the loss on disposal of the shop units was on capital account, and was not therefore deductible against the chargeable profits.

19. In an attempt to displace the clear evidence that the acquisition and sale of the shop units was a capital transaction, Miss L gave evidence. She declared, in her testimony, that the intention of the company was always to sell the shop units and not to retain them for rental income.

In what way Miss L was able to speak authoritatively as regards the *intentions* and *policies* of the company was never explained. We infer from what she told us in evidence that the major decisions of the company were made by the majority shareholder Mr. T who (according to Miss L) was very experienced in the property market. As to what Mr. T’s intentions were, in August 1980, when the shop units were purchased, we have no evidence since he did not give evidence at the hearing before us.

There is no suggestion that the Board of Directors of the company ever discussed the matter prior to the acquisition of the shops in August 1980. Miss L never gave evidence to this effect. Nor were any Board Minutes produced. In our judgment a bare declaration of intent by one Director (who held no shares in the company) is of no evidential weight.

20. The partner of the firm of Messrs M and L, Certified Public Accountants, who was in charge of the audit of the company gave evidence before us. He said that at the time when the Auditors Report for the three years 1981, 1982 and 1983 was signed, he believed the

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classification of the landed properties as “fixed assets” was correct. However, he said in evidence that he did not now believe that to have been correct, because of the sales. We find this statement astonishing. If the classification of an asset as a capital asset is true at the time when the accounts were certified, we fail to see how that classification could become untrue by virtue of a subsequent event such as a sale.

In our judgment, the Commissioner had come to the right conclusion as regards the landed properties and we dismiss the company’s appeal on this point.

Conclusion

21. The company’s appeal fails on both points, and we confirm the assessment as varied by the Commissioner’s determination.