Case No. D45/07

Case stated – application for stating a case – proper question of law – section 69(1) of the Inland Revenue Ordinance ('IRO').

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

Stated Case, No hearing.
Date of decision: 11 March 2008.

The Board in its Decision D35/07 dismissed the taxpayer's appeal for want of a valid notice of appeal.

The taxpayer applied to the Board to state a case on eight questions of law for the opinion of the Court of First Instance.

Held:

1. An applicant for a case stated should identify a question of law which is proper for the Court of First Instance to consider that:

   1.1 triggers the preparation of the case;
   1.2 is not wider than is warranted by the facts; and
   1.3 is not imprecise or ambiguous.

2. The eight questions are quite academic as none of which has anything to do with the conclusion, the *ratio* of the Board that there had been no valid notice of appeal.

3. By way of obiter, the Board concluded that all the eight questions are not proper questions of law as:

   3.1 The answer to Question (1) would not be decisive of the appeal in the taxpayer's favour;

   3.2 Question (2) is based on erroneous premises; so is Question (3) which follows (2);

3.3 Question (4) is a waste of Court's time to entertain an appeal by the taxpayer over an assumption in its favour;

3.4 Question (5) on whether the taxpayer discharged its burden of proof is a thinly disguised attack upon the fact-finding function of the Board;

3.5 Question (6) does not arise from the Decision.

3.6 Question (7) hinges on the fact finding function of the Board;

3.7 Question (8) relates to the costs order made within the discretion of the Board against the taxpayer.

Application dismissed.

Cases referred to:

Commissioner of Inland Revenue v Inland Revenue Board of Review and another [1989] 2 HKLR
Commissioner of Inland Revenue v Inland Revenue Board of Review and Aspiration Land Investment Ltd (1989) 3 HKTC 223
Commissioner of Inland Revenue v Aspiration Land Investment Ltd [1991] 1 HKLR 409
Aust-Key Company Limited v Commissioner of Inland Revenue [2001] 2 HKLRD 275
Same Fast Limited v Inland Revenue Board of Review, (2007-08) IRBRD, vol 22, 321
Kim Eng Securities (Hong Kong) Ltd v CIR [2007] 2 HKLRD 117
Kwong Mile Services Ltd v CIR (2004) 7 HKCFAR 275
Edwards (Inspector of Taxes) v Bairstow & Another [1956] AC 14
So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416

Decision:

Introduction

1. At a hearing before the Board of Review ('**the Board**') held on 14 September 2007, the Taxpayer purported to appeal against the Determination of the Acting Deputy Commissioner of Inland Revenue dated 10 July 2007 ('**the Determination**') 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.

(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.

2. By its Decision dated 27 November 2007, D35/07 ('**the Decision**'), the Board decided in favour of the Commissioner of Inland Revenue ('**the CIR**'); dismissed the Taxpayer's appeal; confirmed the assessments as confirmed by the Acting Deputy Commissioner and ordered the Taxpayer to pay the sum of $5,000 as costs of the Board, which $5,000 should be added to the tax charged and recovered therewith. A copy of the Decision is annexed and marked '**ANNEXURE A**'.

The grounds of appeal to the Board

3. By letter dated 12 July 2007, Ms A of J Enterprise Secretarial & Taxation Limited purported to give notice of appeal on behalf of the Taxpayer against the Determination on the grounds set out in paragraph 2 of the Decision.

The appeal hearing before the Board

4. Neither party called any witness.

5. Mr Alvin Mok Yu-him of J Enterprise Secretarial & Taxation Limited read from a document called 'Submission by the Appellant's Representatives', a copy of which is annexed and marked '**ANNEXURE B**'.

6. Ms Lai Wing-man, senior assessor, submitted a comprehensive written submission and supplemented it with oral submission and answers to questions or comments from the panel

members. A copy of her 'Submission by the Commissioner's Representative' is annexed and marked '**ANNEXURE C**'.

The facts as found by the Board

7. The parties did not agree any facts.

8. Based on documentary evidence, the Board made the findings of fact in paragraphs 24 – 34 of the Decision.

The letter dated 29 November 2007 and the 8 questions

9. By letter dated 29 November 2007, Ms A of J Enterprise Secretarial & Taxation Limited wrote to the Chairman of the Board as follows (written exactly as it stands in the original):

> 'We refer to the Clerk to the Board of Review's letter dated 27 November 2007.
>
> 2. Pursuant to Section 69(1) of the Inland Revenue Ordinance, Cap. 112, we are instructed to hereby make an application requiring the Board to state a case on the questions of law set out hereunder for the opinion of the Court.
>
> 3. The questions of law posed for the Court are:-
>
> (1) Whether the Board has misdirected itself in addressing the Point at Issue in this case, viz., deductibility of the interest expenses, by reference to Section 16(2)(a) of the Inland Revenue Ordinance, whereas both the taxpayer and the Deputy Commissioner of Inland Revenue have no dispute that the condition for deduction referred to in Section 16(2)(d) of the Inland Revenue Ordinance is in point; [x-reference with Paras. 36 & 37 of the Board's Decision where the Board expressed its puzzlement.]
>
> (2) Whether having admitted the facts found by the Deputy Commissioner of Inland Revenue and as reflected in her Determination the Board is justified in finding no evidence on (a) why the $8 million [Company B] loans were raised and (b) the extent to which the Interest Expenses were incurred by the taxpayer in the production of chargeable profits; [x-reference with Paras. 43 & 44 of the Board's Decision]
>
> (3) Whether, following (2) above, the Board is entitled to endorse the extent to which the Deputy Commissioner of Inland Revenue has disallowed a portion of the Interest Expenses claimed;

(4) Whether, having regard to the Clayton' s case having been specifically referred to by both the taxpayer and the Deputy Commissioner of Inland Revenue in the primary dispute in this case over the quantum of Interest Expenses allowable for deduction, the Board is entitled to arrive at its conclusion by "assuming without deciding that the rule in Clayton' s case is applicable in this case"; [x-reference with Para. 55 of the Board' s Decision]

(5) Whether, on a balance of probabilities, the taxpayer has not discharged the onus of proof that any of the assessments appealed against is incorrect or excessive; [x-reference with Para. 55 of the Board' s Decision]

(6) Whether the true and only reasonable conclusion open to the Board, on the facts found by the Board, has been that the taxpayer has not incurred the Interest Expenses in the production of chargeable profits to the extent disallowed by the Deputy Commissioner of Inland Revenue;

(7) In respect of the Profits Tax Assessment for 2004/05, whether the Board has misdirected itself in law in giving undue weight to the loss as assessed by the assessor and has disregarded the true nature of the Notice of Assessment as served on the taxpayer and the tax refunded thereunder;

(8) Whether the Board has been excessive in imposing $5,000 as costs of the Board, having regard to its failures (i) to address the Clayton' s case and (ii) to decide on its applicability to the main issue in this case for the prior years of assessment, and sheerly on its belief that the side issue relating to the 2004/05 year of assessment is an abuse of the appeal process. [x-reference with Para. 59 & 62 of the Board' s Decision]

4. As fees for the Case Stated, we enclose herewith a cheque of HK$770. Please acknowledge receipt and let us have your draft Case Stated as soon as possible for our scrutiny.

5. In view of the heavy costs of the Board imposed on this case and your biased view as expressed in Para. 62 of the Board' s Decision, we herby reserve our right to call for a full transcript of the proceedings before you in the evening of 14 September 2007. We hasten to add that we cannot subscribe to your opinion expressed thereunder, having regard to:

(i) the Questions of Law as listed above arising from the Board' s Decision;

(ii) the long delay by the various Assessors of the Inland Revenue Department in processing the case for Determination, at times with a time lag of over 12 months without any apparent progress on the part of the Inland Revenue Department;

(iii) the fact that it has taken your Board to deliberate for over two and a half months after hearing the case in the evening session of 14 September 2007 and has only been able to make a written Decision on 27 November 2007, and yet without addressing the time-honored case of Clayton' s as to its relevancy and applicability to the present case.

6. Last but not least, should you wish to avoid embarrassment for the Board when the errors and omissions of the Board (as reflected by the above Questions of Law) are surfaced and placed under close scrutiny at the open Court hearing, may we suggest that the case be remitted for re-hearing, or be remitted for the taxpayer as appellant and the Inland Revenue as respondent to work out an apportionment methodology.'

Correspondence on the 8 questions

10. By letter dated 3 December 2007, the Clerk to the Board wrote to J Enterprise Secretarial & Taxation Limited as follows:

'I refer to your letter dated 29 November 2007.

The Taxpayer is invited to make submissions (if the Taxpayer so wishes) on why it is proper for the Court of First Instance to consider the questions identified in your letter and to let me and the Commissioner have the submission by **4:00 p.m. on 2 January 2008**.

The Commissioner has 4 weeks from the date of receipt of the Taxpayer' s submission to comment on the questions (if the Commissioner wishes to). The Commissioner' s response (if any) should be sent to me and the Taxpayer.

The Taxpayer has 4 weeks from the date of receipt of the Commissioner' s response to comment on the same (if the Taxpayer wishes to). The Taxpayer' s comments (if any) should be sent to me and the Commissioner.'

11. By letter dated 4 December 2007, Ms A of J Enterprise Secretarial & Taxation Limited wrote to the Clerk of the Board as follows (written exactly as it stands in the original):

'We refer to your letter of 3 December 2007.

2. The Questions of Law as posed in our letter of 29 November 2007 are self-explanatory and have been drawn up in the light of well-established Case Law on the matter of Question of Law vis-à-vis Question of Facts and previous cases brought before the High Court locally and overseas.'

12. By letter dated 5 February 2008, Mr Johnny Chan, senior Government counsel acting for the CIR, commented on the questions and invited the Board to refuse to state a case. He wrote as follows:

'We act for the Commissioner of Inland Revenue.

We refer to J. Enterprise Secretarial and Taxation Ltd's letter (on behalf of the Taxpayer) to you dated 29 November 2007 and your letter in reply dated 3 December 2007 which was copied to the Commissioner.

We have the following comments on the Taxpayer's proposed questions of law :

Question (1)

We do not understand the question.

There was no dispute that s16(2) was satisfied. However, as the Board quite rightly pointed out in the Decision (para 38), in addition to satisfying s16(2), a taxpayer must also satisfy s16(1), i.e. the taxpayer must prove how the interest expenses in question were incurred in the production of profits in respect of which it was chargeable to profits tax for any period. The Board found no such evidence (para 44).

Answering this question in the way it is presently framed will lead us no where in the Taxpayer's appeal.

Question (2)(a) and (b)

The Taxpayer has only answered enquiries concerning the circumstances in which the $8 million loans were made but has not given any reason as to why the said loans were made.

This question is an attack on the findings of fact and is not a proper question of law.

Question (3)

This question is unclear, and it is dependent on Question (2). If Question (2) is considered to be not a proper question of law, this question must also be similarly classified.

Question (4)

The Taxpayer seems to be saying that the Board has erred in law in failing to properly apply the Clayton's case. While this might well be a proper question of law, the assumption by the Board that the Clayton's rule was applicable (which was not accepted in the Deputy Commissioner's Determination) was actually an assumption in the Taxpayer's favour. We do not understand what the Taxpayer is complaining about and where answering this question will lead us.

Question (5)

This question is far too vague and broad. It seems to be challenging the conclusion the Board has come to on the facts found. In its present form, this is not a proper question of law.

Question (6)

This is a wrong question. The Board is not obliged to find the true and only reasonable conclusion. The Board is only required to determine whether the Taxpayer has discharged the onus of proving that the assessments in question were incorrect or excessive.

Question (7)

We do not understand this question, as the profits/loss and tax thereon if any for the year 2004/2005 was not an issue for determination by the Board. This cannot be a proper question of law.

Question (8)

The imposition of costs is a matter of discretion for the Board, and the Board is entitled to impose costs where the conduct of the appeal so warrants. Even if this is a proper question of law, the point is plainly unarguable.

General Comment

Our view is that the appeal is entirely without merit. The crucial consideration here is whether the interest expenses in question were incurred in the production of the

chargeable profits as provided for under s.16(1) and s.17(1) of the IRO. The Taxpayer has failed to discharge its onus to prove this point.

Even if the Taxpayer is able to frame questions which can technically be questions of law, the Board may still decline an application to state a case when the points of law involved are plainly and obviously unarguable. The Board is referred to the decision in D26/05, 20 IRBRD 174 (attached), where it was held that:

(1) The Board should not accede to a request to state a case unless the applicant can show that a proper question of law can be identified. This must be an arguable question of law which relates to the decision sought to be appealed against, and would not involve an abuse of process for it to be submitted to the CFI for determination.

(2) A dissatisfied party has a right to appeal on a point of law under section 69. The Board hearing such an application should approach the matter with an open mind being aware of the fact that it may not be the best judge of whether its decision is wrong. On the other hand, the function of the Board is not simply to rubber stamp any application where a point of law can be formulated.

(3) Accordingly, the Board may decline an application to state a case under section 69 in the event that the point of law before it is plainly and obviously unarguable.

We respectfully invite the Board to refuse to state a case.'

13. By letter dated 6 February 2008, Ms A of J Enterprise Secretarial & Taxation Limited wrote to the Clerk of the Board as follows (written exactly as it stands in the original):

'We refer to the Department of Justice' s letter dated 5 Feb 2008.

2. All the Department of Justice' s assertions are unfounded. In addition, suffice to say, in response thereto, that:

(a) Re Question of Law No. (1) posed by us that it is crystally clear: the Board at Para 37 of its Decision has referred to its "puzzlement" and that "puzzlement" had arisen from its misdirecting itself to S.16 (2) (a) of the Inland Revenue Ordinance rather than Section 16 (2) (d) thereof. Even DCIR knew at the time of the Determination that S.16 (2) (d) rather than S.16 (2) (a) is at stake in this case. No one should try to call it a horse when it is a deer, as the Chinese saying goes. It is gross injustice for the Department of Justice to twist the texts in the Board of

Review' s Decision to say that Paras 36 & 37 of the Board' s Decision got it correct when the Board admitted its "puzzlement". And that puzzlement arose because of the Board' s mis-reading: instead of referring to Section 16 (2) (d), it read Section 16 (2) (a).

(b) Re Question of Law No. (6): if the Department of Justice is well versed in taxation law and the body of Case Law on tax appeals, the question will not be regarded as wrong.

3. Having regard to our original 8 Questions of Law and our above comments in rebuttal of the CIR' s counsel' s dogmatic allegations, with its apparent intention to prevent the Board to prepare a Case Stated, we would now request you to refer the matter to the Chairman and his members to draft the Case Stated'

Authorities on an application to state a case

14. Section 69 (1) of the Ordinance provides that the decision of the Board shall be final. The finality of the decision of the Board is subject only to an appeal by way of case stated to the Court of First Instance on a question of law. Neither the Taxpayer nor the CIR has a general right of appeal. Appeals from decisions of the Board of Review are restricted to questions of law and are by way of case stated.

15. An applicant for a case stated must identify a question of law which is proper for the then High Court, now Court of First Instance, to consider; the Board is under a statutory duty to state a case in respect of that question of law; the Board has a power to scrutinise the question of law to ensure that it is one which is proper for the court to consider; and if the Board is of the view that the point of law is not proper, it may decline to state a case; per Barnett J in Commissioner of Inland Revenue v Inland Revenue Board of Review and another, [1989] 2 HKLR 40 at page 57 H - J. See also Commissioner of Inland Revenue v Inland Revenue Board of Review and Aspiration Land Investment Ltd (1989) 3 HKTC 223 and Commissioner of Inland Revenue v Aspiration Land Investment Ltd [1991] 1 HKLR 409 at page 417 I.

16. It is clear from the Aspiration case that:

(a) a satisfactory question has to be identified so as to trigger the preparation of the case; (at page 47 I)

(b) the questions the Court is asked to answer 'should be stated clearly and concisely and care should be taken to ensure that the questions are not wider than is warranted by the facts'; (at page 48 E) and

(c) an applicant for a case stated may not rely on a question of law which is imprecise or ambiguous. (at page 50 G)

17. In Aust-Key Company Limited v Commissioner of Inland Revenue, [2001] 2 HKLRD 275 at page 283 B, Chung J said:

'The proper course for the Board to take when it is asked to state a case but which involves no proper question of law is to decline the request. If the applicant (whether the taxpayer or the Revenue) is dissatisfied with the Board's refusal to state a case, it is up to the applicant to decide whether to take further action (and if so, what action to take).'

18. In Same Fast Limited v Inland Revenue Board of Review, (2007-08) IRBRD, vol 22, 321 at paragraphs 6 and 9, Reyes J considered the questions in that case prolix, argumentative, not easy to understand and embarrassing as a whole. Simply on account of their wordiness and opacity, those questions did not appear to the learned judge at all appropriate for a case stated and the learned judge upheld the decision of the Board refusing to state a case.

Board's decision on the Taxpayer's application to state a case

19. It is incumbent on an applicant for a case stated to identify a question of law which is proper for the Court of First Instance to consider. It is not for the Board to frame questions for an applicant. The reason is obvious: the parties know better than anyone else what points they wish to take on the appeal (see the Aspiration case at page 48 J).

20. For reasons given in paragraphs 4 – 6 of the Decision, the Board concluded that:

'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.'

21. None of the 8 questions has anything to do with this conclusion, the *ratio* of the Board's Decision. Any answer which the Court may give to the 8 questions (assuming for present purposes that they are proper questions of law) will not change the outcome of the appeal in respect of the assessments. The questions are quite academic. None of them is a proper question of law and we decline to state a case.

General comment

22. The above disposes of the Taxpayer's application to state a case. What we state below is necessarily *obiter*.

23. We cite the Same Fast case because we consider the questions in this case argumentative, not easy to understand and embarrassing as a whole and they do not appear at all to us appropriate for a case stated.

Question (1)

> '(1) Whether the Board has misdirected itself in addressing the Point at Issue in this case, viz., deductibility of the interest expenses, by reference to Section 16(2)(a) of the Inland Revenue Ordinance, whereas both the taxpayer and the Deputy Commissioner of Inland Revenue have no dispute that the condition for deduction referred to in Section 16(2)(d) of the Inland Revenue Ordinance is in point; [x-reference with Paras. 36 & 37 of the Board's Decision where the Board expressed its puzzlement.]'?

24. The answer to this question is not decisive of the appeal in the Taxpayer's favour. As the Board stated in paragraph 38 of the Decision, a taxpayer must also satisfy section 16(1) and is not caught by section 17(1) before loan interest may be deducted. For reasons given below, there is no proper question on the Board's conclusions on section 16(1) and section 17(1). Thus question (1) is not a proper question.

Question (2)

> '(2) Whether having admitted the facts found by the Deputy Commissioner of Inland Revenue and as reflected in her Determination the Board is justified in finding no evidence on (a) why the $8 million [Company B] loans were raised and (b) the extent to which the Interest Expenses were incurred by the taxpayer in the production of chargeable profits; [x-reference with Paras. 43 & 44 of the Board's Decision]'?

25. The premise of this question is wrong. The Board did not '[admit] the facts found by the [Acting] Deputy Commissioner of Inland Revenue as reflected in her Determination'. As stated in paragraph 23 of the Decision, the Board made the findings of fact in paragraphs 24 – 34 of the Decision based on the documents placed before the Board, including in particular, the Taxpayer's financial statements. Question (2) is not a proper question because it is based on an erroneous premise.

26. Further, the Board pointed out in paragraphs 43 and 44 of the Decision that:

> '(43) There is no evidence on *why* the $8 million [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.'

27. There is no question on what findings of relevant facts that the Board should have made, see page 57 G in the Aspiration case. The approach of this question is wrong. It is not a proper question.

Question (3)

> '(3) Whether, following (2) above, the Board is entitled to endorse the extent to which the Deputy Commissioner of Inland Revenue has disallowed a portion of the Interest Expenses claimed'?

28. As question (2) is not a proper question, it follows that question (3) is not a proper question.

29. Further, it is not clear what is being challenged. The *effect* of the Decision is to uphold the Determination. It is not clear which conclusion or conclusions is or are being challenged and for this further reason, question (3) is not a proper question.

Question (4)

> '(4) Whether, having regard to the Clayton's case having been specifically referred to by both the taxpayer and the Deputy Commissioner of Inland Revenue in the primary dispute in this case over the quantum of Interest Expenses allowable for deduction, the Board is entitled to arrive at its conclusion by "assuming without deciding that the rule in Clayton's case is applicable in this case"; [x-reference with Para. 55 of the Board's Decision]'?

30. It is an assumption in favour of the Taxpayer. It is a waste of the Court's time to entertain an appeal by the Taxpayer over an assumption in its favour. Question (4) is not a proper question.

Question (5)

> '(5) Whether, on a balance of probabilities, the taxpayer has not discharged the onus of proof that any of the assessments appealed against is incorrect or excessive; [x-reference with Para. 55 of the Board's Decision]'?

31. In the Aspiration case, the Board held in favour of the taxpayer on the discharge of the onus of proof. The second question in that case was:

> 'Whether the Board applied correctly the provision of s. 68(4) of the Inland Revenue Ordinance in holding that the onus of proof that the assessment was erroneous was satisfied by Aspiration Land Investment Ltd.?' (at page 44 C)

At page 50 G - J, Barnett J held that this was not a proper question of law:

> *'Mr. Feenstra maintained that the second question is also a question of law. He recognised that the Board expressly stated where the onus lay, i.e. on the taxpayer. He maintained, however, that the evidence before the Board may have been such that the court could consider that on the proper application of the onus of proof, certain inferences of fact were not properly made by the Board and insupportable. In plain terms, if there was evidence going either way, it could not be said that, on the balance of probabilities, the taxpayer had proved its case.*
>
> *In my view, this is a thinly disguised attack upon the fact-finding function of the Board. Unless there was no evidence to support a finding of primary fact, or unless the primary facts could not support an inference found by the Board, whether the onus was discharged was a question of degree which depends upon the evaluation by the tribunal of fact.*
>
> *To impugn the Board's evaluation would be to undermine the whole purpose of the Board as a fact-finding tribunal. Unless the Commissioner can identify findings of fact for which there is no evidence or inferences which are wholly unsupportable and thus wrong in law, this question is untenable. I do not regard the second question as a question of law.'*

32. For similar reasons, we do not regard question (5) in this case as a question of law.

Question (6)

> '(6) Whether the true and only reasonable conclusion open to the Board, on the facts found by the Board, has been that the taxpayer has not incurred the Interest Expenses in the production of chargeable profits to the extent disallowed by the Deputy Commissioner of Inland Revenue'?

33. It does not arise from the Decision. The Decision rested primarily on the failure of the Taxpayer to discharge its onus of proof.

34. Further, we agree with senior Government counsel that this is the wrong question.

35. **Even if** the Board had decided that the Taxpayer had not incurred the interest expenses in the production of chargeable profits to the extent disallowed by the Deputy Commissioner, the correct question is not whether that was the true and only reasonable conclusion open to the Board. The correct question is whether 'the true and only reasonable conclusion contradicts' the determination appealed against, see Kim Eng Securities (Hong Kong) Ltd v CIR [2007] 2 HKLRD 117 at paragraph 55, quoting Kwong Mile Services Ltd v CIR *(2004) 7 HKCFAR 275* at pages 288D-E and 291J-292B and Edwards (Inspector of Taxes) v Bairstow & Another [1956] AC 14 at page 36.

Question (7)

> '(7) In respect of the Profits Tax Assessment for 2004/05, whether the Board has misdirected itself in law in giving undue weight to the loss as assessed by the assessor and has disregarded the true nature of the Notice of Assessment as served on the taxpayer and the tax refunded thereunder'?

36. Weight is a matter of degree for the Board in the performance of its fact finding function. This is not a question of law.

Question (8)

> '(8) Whether the Board has been excessive in imposing $5,000 as costs of the Board, having regard to its failures (i) to address the Clayton's case and (ii) to decide on its applicability to the main issue in this case for the prior years of assessment, and sheerly on its belief that the side issue relating to the 2004/05 year of assessment is an abuse of the appeal process. [x-reference with Para. 59 & 62 of the Board's Decision]'?

37. The decision whether to order costs and, if so, the amount of costs, is a matter which lies within the discretion of the Board having regard to the merits of the appeal and the conduct of the proceedings before the Board. Appellate courts are slow to interfere with a lower court's or tribunal's exercise of discretion on costs except on narrow well-defined grounds. Excessiveness is a matter of degree. None of the matters put forward in question (8) is a ground for interference. Question (8) does not involve a question of law fit for the determination by the court, *cf* the judgment of Chu J in So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416, paragraphs 16 – 21, on the question of the Board's refusal to grant an adjournment in that case.

Conclusion

38. For the reasons given above, we refuse the Taxpayer's application and decline to state a case.

ANNEXURE A

D35/07

BOARD OF REVIEW

Appeal by The Appellant

(Date of Hearing: 14 September 2007)

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D E C I S I O N

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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

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.

(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)

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

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.

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-yee, 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.

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:

	1994/95	1995/96	1996/97	1997/98	1998/99
	$	$	$	$	$
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
	1999/2000	2000/01	2001/02	2002/03	2003/04
	$	$	$	$	$
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:

	1995	1996	1997	1998	1999
	$	$	$	$	$
Interest in associated companies					

Company C					
Share capital	1,000,000	1,000,000	1,000,000		
Current account *	1,908,296	1,908,296	1,908,296		
	2,908,296	2,908,296	2,908,296		
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
		2,080,000	2,080,000	2,080,000	2,080,000
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
		9,100,000	9,100,000	9,100,000	9,100,000
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
		5,000,000	5,000,000	5,000,000	5,000,000
Total interest	2,908,296	19,088,296	19,088,296	16,180,000	16,180,000
Current assets					
Loan to a shareholder	7,357,953	-	-	-	-
Other current assets	40,572	26,075	6,025	5,475	3,306
	7,398,525	26,075	6,025	5,475	3,306
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
	9,607,100	19,022,020	19,597,920	17,321,691	17,308,838

	2000	2001	2002	2003	2004
	$	$	$	$	$
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
	2,624,133	2,624,133	2,631,466	2,635,766	2,646,840
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
	8,016,333	8,016,333	8,024,667	8,024,667	9,284,723
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
	4,423,334	4,423,334	4,430,667	4,436,367	4,448,091
Total interest	15,063,800	15,063,800	15,086,800	15,096,800	16,379,654

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
	2,362,842	7,861	745	5,955,992	4,284,775
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	-
	19,162,106	17,637,771	16,758,638	20,702,135	19,178,241

* interest bearing

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

	1994/95	1995/96	1996/97	1997/98	1998/99
	$	$	$	$	$
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)	(69,792)	(602,896)	(595,950)	(629,612)	10,684
Less: Loss b/f set-off					(10,684)
Net assessable profits	Nil	Nil	Nil	Nil	Nil
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	69,792	672,688	1,268,638	1,898,250	1,887,566

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

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:

> $584,072 [Paragraph 26] x {$7,357,953 / ($2,908,296 + $7,398,525)} [Paragraph 27] = $416,964

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:

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

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:

(a) Profits tax assessment 1998/99

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

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)
Add: Interest disallowed *[Note (ii)]*	617,230
Assessable profits	8,253
Tax payable thereon	1,320

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)
Add: Interest disallowed *[Note (iii)]*	777,970
Loss for the year c/f	(52,675)

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

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

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

(e) Profits tax assessment 2002/03

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

(f) Profits tax assessment 2003/04

	$
Assessable profits per Paragraph 28	1,135,530
Tax payable thereon	198,717

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, procuration 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:

'(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 ..." '

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*

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

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.

ANNEXURE B

Your Ref. B/R 31/07 Our Ref: X/XXX/XXX

Mr Chairman, Members of the
Board of Review (I.R.O.)

Submission by the
Appellant's Representatives

Appeal to the Board of Review
Profits Tax Assessments
Raised on The Appellant

The Appellant Company's only two shareholders and directors are aged almost 90 and are of frailing health, with difficulties in moving around. That is why we have not arranged for them to come along to give evidence. Nor do we see the need for the old couple to prepare an affidavit or affirmation, because the facts of this case are straight forward enough.

2. The Company's grounds of appeal are set out on Page 1 and Page 175 of the Board of Review's Bundle of Documents. The gist of the matter is the Interest Expanses disallowed by IRD.

3. To cut the story short, the Company's case is that the Interest Expenses it claimed satisfy the condition at section 16(2)(d) of the Inland Revenue Ordinance and should be allowed for deduction. Section 16(2)(d) reads as follows:

'The condition for the application of subsection (1)(a) is satisfied if-

(d) the money has been borrowed from a financial institution or an overseas financial institution.'

Subsection (1) of section 16 reads as follows:

'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 condition for the application of this paragraph is satisfied under subsection (2), and subject to subsections (2A), (2B) and (2C), sums payable by such person by way of interest on any money borrowed by him for the purpose of producing such profits, and sums payable by such person by way of legal fees, procuration fees, stamp duties and other expenses in connection with such borrowing;'

Subsections (2A), (2B) and (2C) are not applicable in this case, as they are provisions newly enacted in mid-2004.

4. The Interest Expenses in question were incurred on loans from a related company which is a licensed Finance Company, with the interest always calculated by reference to market rates. Therefore such interest qualifies for deduction under section 16(2)(d) as arising from loans borrowed from a financial institution.

5. In the early years of the 1990s the Company, although initially armed with substantial paid-up capital, had to borrow heavily from shareholders (free of interest) and the aforesaid Finance Company (to the extent of $8M and interest bearing), in order to accommodate its property investment projects on the Mainland. As the property investment projects on the Mainland would not give rise to Hong Kong chargeable profits, IRD disallowed part of the Interest Expenses by using the usual pro rata formula. But the gross injustice in this case is that IRD has sought to perpetuate the pro rata apportionment forever!

6. The Company's case is therefore a very simple one. Since embarking on trading activities, with cashflows coming in and going out in the course of its daily operations, and with monies (invariably in Hong Kong currency) deriving from trading operations being fungible with any other sources of cash flows into and out of the Company's business, IRD is most irrational in sticking to the initial formula for annually disallowing a portion of the Interest Expenses. IRD's view is, in short, that the property investment projects on the Mainland have been substantially financed by the interest-bearing loans. The Company's contention is, in short, that the 'hole' made open by diverting funds to the Mainland for investment has long been refilled by the sale proceeds in tens of millions dollars from trading of textile goods operations in subsequent years. And such sale of textile goods monies of the Company are fungible with the original loan funds in the early 1990s, so that IRD should view the Interest Expenses incurred in the years in question as arising from general operations of the business.

7. The Company seeks to rely its contention on the Clayton's Rule developed by the UK Court in 1816, which has become a time-honoured principle in dealing with fungible monies. The rule in Clayton's Case (or, to give it its full legal name and citation: Devaynes v Noble

(Clayton's Case) (1816) 1 Mer 572) is a common law presumption in relation to the distribution of monies from a bank account. The rule is based on the simple notion of first-in, first-out to determine the effect of payments from an account, and will normally apply in the absence of evidence of any other intention. Applying the Case to the Company's present case, the loan funds from the Finance Company in the early 1990s and placed with the property projects on the Mainland created a 'hole' in the Company's vault. Since funds flowing into and out of the Company's vault are fungible, the sale proceeds of its textiles trade would fill up the 'hole' particularly when the turnover was huge enough. Certainly, a 'hole' could later re-surface when further spendings are necessary. However, this is just normal business operations. Monies keep flowing in and going out. With sophiscated public companies, they would draw up Cashflow Statements on an annual group basis to reflect the liquidity. All in all, is a case like this, it is most unfair that the Company be held forever inadmissible for part of the interest costs simply because at the very initial stage, interest bearing loan funds were appropriated to pay for the property investments outside Hong Kong.

8. Let met draw an analogy. Mr Chairman, this month you buy a new stored value card of $100 for 100 minutes usage on your mobilephone. The Clerk to the Board, in handling a case of great emergency, borrows your mobilephone and has talked talked talked for 50 minutes. You therefore bill him $50 at the end of the month. Next month for your sole usage you recharged your stored value card with the telecom company for $100, and in the 3rd month recharged again for your sole usage your stored value card for yet another $100. Now the 'minutes' of usage on your mobilephone is fungible. You are not entitled to appropriate, in the 2nd month and the 3rd month, 50% of the usage to the Clerk to the Board.

9. Should Mr Chairman and Members of the Board care to read through the Bundle compiled by the Clerk to the Board of Review, you will note that IRD has aggravated the infliction of pains on the Company' s owners and caused further injustice, in handling this case, by—

(a) sitting idle on this case for tens of months at the Assessing Section and the Appeals Section of IRD, without trying to discern whether the Clayton's Principle should apply to this case;

(b) refusing to follow our suggestions to adjust their draft Statement of Facts, so as to present all facts in normal chronological order [to save all parties' time, we consider that by now there is no point to remit the case to have the Facts re-drawn by agreement by both the Appellant and the Respondent—suffice to say that a Statement of Facts, based on which CIR or DCIR would make a determination of the case, should comprise facts and not a mixed bag of facts and contentions and should understandably be presented in chronological order, as not to cause bias or prejudice, or distortion or confusion of the history of a case.]

(c) refusing to determine 2004/05 involving the same issue of Interest Expenses, on the pretext that no 2004/05 assessment was issued. The Unit 1 assessor did categorically issue a Notice of Assessment with tax refund to the Company. The Company responded by a Notice of Objection. IRD has not entertained the Company's objection against the assessment, claiming no notice of assessment has been issued. IRD has not withdrawn the Notice of Assessment. Nor has it relied on section 58(1) of IRO as to that notice's validity or propriety if it is now held out to be one other than an ordinary Notice of Assessment. This being the case, that notice stands good as an ordinary Notice of Assessment. The Company did lodge a valid objection. IRD is obliged to acknowledge its receipts. Failing to come to settlement by agreement, IRD should have it determined by CIR or DCIR. This has not been done, notwithstanding the Company drawing their attention at the bottom of Page 171 of the Board's Bundle.

10. Coming back to our criticism at the above Para 9(b) re IRD's Statement of Facts (in support of the Determination) resulting from Appeals Officer's refusal to listen to us. The most significant aspects are;

(1) The Company's reliance on Page 169 which is a historical presentation of 'Sources and Application of Funds' of the Company. On Page 173 2nd paragraph from last, we told the Appeals Officer to lay it at the beginning of draft Fact 14(b) [now re-numbered as Fact 13(b) because the original Fact 13 has since been purged by the Appeals Officer].

(2) The paragraph now re-numbered as Fact (14) is not a pertinent fact per se, but a reproduction of a dictionary entry, purported (apparently) to back up the Appeals Officer's contention.

11. All in all, it is a great pity that the Appeals Officer has not cared to make searches from IRD's database or the Board of Review (IRO)'s database on cases previously decided by reference to the Clayton's Rule.

12. Without further ado, may we urge you to find:

(a) That by reference to the Clayton's Principles or Rule, IRD's assessments should be set aside for want of justice by perpetuating the disallowance of Interest Expenses (it is unjust to continue to disallow Interest Expenses year after year, disregarding the fungible monies coming in and going out in the course of daily business activities and the fact that Interest Expenses incurred were incidental to daily business operations);

(b) That alternatively, that the Board remit this case to the Company as Appellant and IRD as Respondent to work out a true and fair apportionment by reference to whatever reasonable basis of estimation.

-end-

ANNEXURE C

B/R 31/07
IRA/2/4291

Appeal to the Board of Review
Profits Tax Assessments 1998/99, 1999/2000, 2002/03 and 2003/04
['The Appellant']

Submission by the Commissioner's Representative

Mr Chairman, Members of the Board,

The issue

1. The issues for the Board to decide are:

    (a) whether the interest expenses of $586,136, $584,000, $617,067, $778,666, $780,800 and $778,666 incurred by the Appellant for the years of assessment 1995/96 to 2000/01 respectively should be fully tax deductible; and

    (b) whether the adjusted losses of $602,896, $595,950 and $629,612 (after deducting the interest expenses referred to in paragraph (a) above) claimed by the Appellant for the years of assessment 1995/96 to 1997/98 respectively should be tax allowable and carried forward for set off against its assessable profits for subsequent years.

2. The Appellant claims that [B1, p.1]:

    (a) the assessments are excessive;

    (b) the interest expenses have been wrongly disallowed; and

    (c) the Deputy Commissioner has misdirected herself in the applicability of the Clayton's rule to its case.

3. The Revenue submits that:

(a) The Appellant has failed to demonstrate that the purpose of each of its borrowings, upon which the interest expenses were incurred, was entirely for the production of chargeable profits, whether by application of the Clayton's rule or otherwise.

(b) None of the expenses including the interest expenses claimed by the Appellant during the years of assessment 1995/96 to 1997/98 were incurred in the production of chargeable profits. The expenses incurred should be disallowed in total by virtue of sections 16(1) and 17(1)(b) of the Inland Revenue Ordinance ['the IRO']. It follows that no tax loss was sustained during these 3 years.

(c) In respect of the years of assessment 1998/99 to 2000/01, the Appellant had substantial investments in associated companies (comprising share capital and non-interest bearing loans) which did not produce chargeable profits. Part of the interest expenses was incurred for the purpose of financing these non-income producing assets, and such amounts should not be deductible by virtue of sections 16(1) and 17(1)(b) of the IRO. In the absence of specific earmarking of funds, the formula used by the Revenue in apportioning the interest amounts by reference to the ratio which the Appellant's non-income producing assets bore to its total assets is reasonable and appropriate.

The relevant statutory provisions

Ascertainment of chargeable profits

4. Section 16(1) of the IRO provides that [R2, p.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, procuration fees, stamp duties and other expenses in connection with such borrowing;'

Deductions not allowed

5. Section 17(1) of the IRO provides that [R2, p.4]:

'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 –

(a) ....

(b) subject to section 16AA, any disbursements or expenses not being money expended for the purpose of producing such profits;'

Burden of proof on appeal to the Board of Review

6. Section 68(4) of the IRO provides that [R2, p.9]:

'The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.'

General apportionment of outgoings and expenses

7. Rule 2A(2) of the Inland Revenue Rules ['the IRR'] provides that [R2, p.12]:

'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.'

The applicable legal principles

The Clayton's rule (1816) 1 Mer 572 [R2, page 14-27]

8. The rule in Clayton's case is a common law presumption in relation to the distribution of monies from a bank account. The rule is based upon the deceptively simple notion of first-in, first-out to determine the effect of payments from an account, and will normally apply in the absence of evidence of any other intention.

9. In Clayton's case, one of the partners of a firm with which Clayton had an account died. The amount then due to Clayton was £1,717. The surviving partners, thereafter paid to Clayton more than that amount while Clayton himself, on his part, made further deposits with the

firm. On the firm being subsequently adjudged bankrupt, it was held that the estate of the deceased partner was not liable to Clayton, as the payments made by the surviving partners to Clayton must be regarded as completely discharging the liability of the firm to Clayton at the time of the particular partner's death. It is based on the legal fiction that, if an account is in credit, the first sum paid in will also be the first to be drawn out and, if the account is overdrawn, a payment in is allocated to the earliest debit on the account which caused the account to be overdrawn.

10. Grant MR said at page 608 and 609 [R2, page 26]:

> *'….this is the case of a banking account, where all the sums paid in form one blended fund, the parts of which have no longer any distinct existence. …. In such a case, there is no room for any other appropriation than that which arises from the order in which the receipts and payments take place, and are carried into the account. Presumably, it is the sum first paid in, that is first drawn out. It is the first item on the debit side of the account, that is discharged, or reduced, by the first item on the credit side. The appropriation is made by the very act of setting the two items against each other…. When there has been a continuation of dealings, in what way can it be ascertained whether the specific balance due on a given day has, or has not, been discharged, but by examining whether payments to the amount of that balance appear by the account to have been made? You are not to take the account backwards, and strike the balance at the head, instead of the foot, of it.'*

Application of the Clayton's rule

11. It is generally applicable in cases of running accounts between two parties, e.g., a banker and a customer, moneys being paid in and withdrawn from time to time from the account, without any specific indication as to which payment out was in respect of which payment in. However, the rule is only a presumption, and can be displaced.

12. In Barlow Clowes (International) Ltd (in liq) and others v Vaughan and others, [1992] 4 All ER 22 [R2, page 28-52], it was held that the rule was not applied because there was evidence that the parties intended to participate in a collective investment scheme. Barlow Clowes, a deposit-taking company registered in Gilbraltar, had promoted and managed certain investment plans before it went into liquidation. However, the funds for the investments had been misapplied and at the time of the collapse the amount of moneys and assets available for distribution to investors was far less than the amount of the investors' claims. The receivers then brought proceedings before the Court for directions as to the basis on which the moneys and assets should be administered. It was held that in view of the basis on which the investors had contributed to the investment plans, which was that they intended to participate in a collective investment scheme by which their money would be mixed together and invested through a common fund, it would be contrary to the presumed intention of the investors to distribute what remained from the common

misfortune by the application of the first in, first out rule so that those who had invested first could expect less. Instead, the presumed intention must have been that Clayton's rule would not apply and that all the assets available for distribution would be shared pari-passu rateably in proportion to the amounts due to them.

13. In the case of CA Pacific Securities Limited, HCCW 37/1998, unreported, 20 December 2000 [R2, page 53-70], it was held that the Clayton's rule was not applied because it was unjust, inapplicable and impractical. Upon the collapse of the securities brokerage firm, there was a shortfall of shares available for distribution amongst the clients. One of the matters brought before the Court was the application for directions on the allocation of the remaining shares. In considering the proper solution, the Court had been referred to, amongst others, the rule in Clayton's case. Judge Yuen found that there would be injustice of applying the rule and said the following at paragraph 59 [R2, page 64]:

> *'However, the rule in **Clayton's** case was based on presumed intention. In the present case, there are not facts which can support any presumed intention that CAP Securities would have first withdrawn for delivery to the Lenders the shares which had been deposited with them first. None of the documentation signed by either the cash clients or the margin clients supports the presumption of such an intention, nor did any past course of dealings between CAP Securities and any of its clients. To apply the "first in, first out" rule in **Clayton's** case here would be contrary to the parties' intentions and would work arbitrary and unjust results.'*

It was also found that the rule was impractical. At paragraph 61, Judge Yuen said [R2, page 65]:

> *'Even if it did apply on the basis that there is no real distinction between moneys in a bank account and shares in CCASS, it would be impractical to apply that rule in the present case. The Liquidators have estimated that a detailed **Clayton's** case type tracing process would cost $187 million and would take 5 years to complete. The cost and time required for this method of allocation render it unacceptable. It could not possibly be in the interests of any of the clients for them to have to spend so much and to wait so long, for a potentially unjust result not intended by any of them.'*

14. Though the Clayton's rule is also applicable to the appropriation of payments between any trader and his customer where there is an account current or running account, it is not an invariable one. The rule is only a presumption and would not be applicable if circumstances show that the parties intended otherwise. In Lee Ying Wah v Yuen To & Another, HCA No. 976 of 2001, 31 May 2002 [R2, page 71-82], the defendants bought goods on credits and made lump sum payments from time-to-time, without designating a payment for a particular batch of goods. These payments were reflected in the statements of accounts sent by the seller which had been

confirmed by the defendants with their chop. The seller assigned its rights in respect of outstanding transactions to Lee Ying-wah, the plaintiff, who claimed for those transactions. The defendants argued that although they might have been indebted to Lee, they had fully paid Lee in respect of the specific transactions claimed by Lee. The Court had to consider the effects, if any, of the Clayton's case. At paragraphs 6 and 7 of his judgment, Deputy Judge Lam (as he then was) referred to the origin of the Clayton's rule and said the following [R2, page 73-74]:

> '6. ..... *It has to be remembered that Clayton's case was about the appropriation of payments in the case of a banking account. There was a running account with credits and debits from time to time....*
>
> 7. *The rule is also applicable to appropriation of payments between a trader and his customer if there is a running account arrangement, ... However, the rule is not an invariable one. ....*
>
> 8. .....
>
> (b) *The rule is only a presumption in cases of running account. It would not be applicable if circumstances show that the parties intended otherwise.'*

The Court held that according to the monthly statements confirmed by the defendants, the normal practice between the parties was the application of the Clayton's rule. The appeal was dismissed.

Interest deduction under section 16(1)(a)

15. To determine whether interest is deductible under section 16(1)(a), the relevant question is why was the loan was raised. If the purpose of the borrowing was for producing profits, the interest on the borrowing should be deductible accordingly. On the issue of construction of section 16(1)(a), the Court of Final Appeal in Zeta Estates Limited v Commissioner of Inland Revenue, [2007] 2 HKLRD 102 [R2, page 102-116], approved the approach adopted in the Australian case Commissioner of Taxation v Roberts and Commissioner of Taxation v Smith, (1992) 23 ATR 494, rather than the South African. At page 113E [R2, page 113], Lord Scott of Foscote said the following when referring to that Australian case:

> *'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." …'

Apportionment of expenses

16. In So Kai Tong v Commissioner of Inland Revenue, [2004] 2 HKLRD 416 [R2, page 83-101], Chu J held that, despite the absence of the words 'wholly and exclusively' in section 16(1), the Commissioner is entitled to ascertain the extent to which an expenses is incurred in the production of chargeable profits. At page 427E-G [R2, page 94]:

'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 production of chargeable profits....'

At page 429A-D [R2, page 96]:

'In performing the task, regard will have to be made to r.2A of IRR, ….. an objective approach is called for in determining what part of the outgoing or expense is deductible.'

17. In D68/87, IRBRD, vol 3, 105 [R2, page 117-123], the taxpayer's income consisted of both assessable and non-assessable portions, and the taxpayer had not designated particular borrowings to particular investments and loans. The Board held that in the circumstances, it is appropriate for the Commissioner to adopt an artificial formula, provided such formula is reasonable and fair. The Board said the following at page 109 [R2, page 121]:

'Clearly some formula must be adopted which will be reasonable and fair for both the Taxpayer and the Commissioner. The Taxpayer has not allocated its shareholders' funds to long term equity investments and likewise has not attempted to designate the different moneys which it has borrowed amongst the different investments and loans which it has made, and some artificial formula must be found.'

As to the selection of the correct formula, the Board found that the correct way of apportioning the total interest expense was to do so on an investment or moneys invested basis.

18. In D22/88, IRBRD, vol 3, 278 [R2, page 124-128], the taxpayer was a finance company and its funds were mixed together in one account. In the course of its business, the taxpayer made loans to local customers which produced assessable profits but also deposited funds offshore and invested in associated companies which produced non-assessable profits. The taxpayer claimed a deduction for all of its interest expenses. To determine this question, Board was of the view that [R2, page 127]:

> *'.... The key words are "money borrowed for the purpose of producing such profits" and the decisive question is what was the purpose of the borrowings.'*

The Board found as a fact, as borne out by the taxpayer's accounts, that it was always the taxpayer's policy to use borrowed funds exclusively to make taxable investments, and use shareholders' funds exclusively to make exempt investments. In the circumstances, the taxpayer was entitled to deduct all of its interest expenses.

19. In D66/88, IRBRD, vol 4, 85 [R2, page 129-138], the taxpayer borrowed large sums from banks and incurred interest expenses. The borrowings were not earmarked for any specific purpose. Some of the borrowed funds were used to produce assessable profits while others were not. In the absence of sufficient information to identify the source, period and purpose of each of the taxpayer's borrowings, the Board found that the only practicable basis for apportioning the interest expense was to use the IRD's formula. The formula was based on the assets held by the taxpayer at year-end which was reasonable and appropriate.

The relevant facts

20. The Revenue submits that the background facts of the present case have been summarized in the determination issued by the Deputy Commissioner of Inland Revenue [B1/5-174]. The Board is invited to refer to paragraphs 1(1) to 1(15) of the determination [B1/5-11] as to the relevant facts in this appeal. The salient facts are as follows:

21. The Appellant is a private company incorporated in Hong Kong on 12 March 1964. At the relevant times, it made up its accounts to 31 March annually.

22. In the Appellant's accounts for the period from 1 January 1977 to 31 March 1995, it declared that it ceased trading on 31 December 1976 and remained dormant until the year commencing on 1 April 1994 when it recommenced trading.

23. (a) By two loan agreements both dated 1 October 1993, the Appellant borrowed from Company B two loans in the total amount of $8,000,000. Company B was a licensed finance company and had common shareholders and directors with the Appellant. Interest on the loans was charged at the following rates:

	Period covered	Monthly interest rate
(i)	01-04-1994 to 28-02-1998	0.6%
(ii)	01-03-1998 to 31-03-1998	1.0%
(iii)	01-04-1998 to 31-01-2000	0.8%
(iv)	Since 01-02-2000	No interest paid

(b) The loans from, and interest due to, Company B were included in the Appellant's accounts as sundry creditors and accrued charges.

(c) The loans remained unpaid until 28 February 2004 when there was a partial repayment in the amount of $200,000.

24. The Appellant's profit and loss accounts for the years ended 31 March 1995 to 2004 showed, among others, the following particulars:

	1994/95	1995/96	1996/97	1997/98	1998/99
	$	$	$	$	$
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)
Profits/(Loss)	(486,756)	(607,371)	(595,950)	(632,617)	10,684

	1999/2000	2000/01	2001/02	2002/03	2003/04
	$	$	$	$	$
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.

25. The interest expenses charged in the accounts were as follows:

Year ended	Bank overdraft interest	Loan interest (Company B)	Total	

	$	$	$	
31-3-1995	72	584,000	584,072	[B1, p.28]
31-3-1996	536	585,600	586,136	[B1, p.46]
31-3-1997	-	584,600	584,000	[B1, p.53]
31-3-1998	-	617,067	617,067	[B1, p.60]
31-3-1999	-	778,666	778,666	[B1, p.79]
31-3-2000	-	780,799	780,800	[B1, p.98]
31-3-2001	-	778,666	778,666	[B1, p.114]

26. The Appellant's balance sheets as at 31 March 1995 to 2004 showed, among others, the following particulars:

	1995 $	1996 $	1997 $	1998 $	1999 $
Interest in associated companies -					
Company C					
Share capital	1,000,000	1,000,000	1,000,000		
Current account *	1,908,296	1,908,296	1,908,296		
	2,908,296	2,908,296	2,908,296		
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
		2,080,000	2,080,000	2,080,000	2,080,000
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
		9,100,000	9,100,000	9,100,000	9,100,000
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
		5,000,000	5,000,000	5,000,000	5,000,000
Total interest	2,908,296	19,088,296	19,088,296	16,180,000	16,180,000
Current assets -					
Loan to a shareholder	7,357,953	-	-	-	-
Other current assets	40,572	26,075	6,025	5,475	3,306
	7,398,525	26,075	6,025	5,475	3,306
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
	9,607,100	19,022,020	19,597,920	17,321,691	17,308,838

	2000	2001	2002	2003	2004
	$	$	$	$	$
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
	2,624,133	2,624,133	2,631,466	2,635,766	2,646,840
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
	8,016,333	8,016,333	8,024,667	8,024,667	9,284,723
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
	4,423,334	4,423,334	4,430,667	4,436,367	4,448,091
Total interest	15,063,800	15,063,800	15,086,800	15,096,800	16,379,654
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
	2,362,842	7,861	745	5,955,992	4,284,775
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	-
	19,162,106	17,637,771	16,758,638	20,702,135	19,178,241

* interest bearing

27. The Appellant declared the following assessable profits/adjusted loss in its Profits Tax computations:

	1994/95	1995/96	1996/97	1997/98	1998/99
	$	$	$	$	$
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)	(69,792)	(602,896)	(595,950)	(629,612)	10,684
Less: Loss b/f set-off					(10,684)

Net Assessable Profits	Nil	Nil	Nil	Nil	Nil
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	69,792	672,688	1,268,638	1,898,250	1,887,566

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

28. In arriving at the adjusted loss for the year of assessment 1994/95, the Appellant 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:

$$\text{interest expenses} \times \frac{\text{loan to a shareholder}}{\text{total interest in associated cos.} + \text{total current assets}}$$

29. 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. Moreover, 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:

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

30. Accordingly, the assessor issued to the Appellant the 1998/99, 1999/2000, 2002/03 and 2003/04 profits tax assessments to disallow in full the losses declared by it for the years of assessment 1995/96 to 1997/98 and add back part of the interest expenses claimed for the years of assessment 1998/99 to 2000/01 using the above formula.

31. The Appellant objected against the profits tax assessments on the grounds that prior years' losses had not been allowed for set-off as claimed and that the interest expenses were incurred by it in the production of chargeable profits and should be allowed for deduction.

The Appellant's arguments

32. The Appellant claims that according to the Clayton's case, subsequent first inflow of funds would have filled up the 'hole' arising from the first outflow of funds [R1, page 36]. In particular, the Appellant's case is that the 'hole' arising from the first outflow of funds resulting from the initial investments in associated companies had been filled up by the subsequent first inflow of funds derived from the sale proceeds of goods. The Appellant claims that as it had conducted active trading business in the course of the relevant years, the interest expenses incurred in the later years had arisen from trading operations and should be admissible for deduction.

The Revenue's submission

33. The Revenue submits that whether or not the expenses, in particular the interest expenses, were incurred by the Appellant in the production of chargeable profits is a question of fact. The onus is on the Appellant to prove its case.

34. Apart from mere claims, the Appellant has failed to show how the entire amount of the borrowed funds obtained from Company B, upon which the interest expenses were incurred, was used for the purpose of producing chargeable profits, whether by application of the Clayton's rule or otherwise. The Appellant has not produced any bank statements or ledger accounts to identify (a) the use to which the loan money obtained from Company B was put throughout the periods concerned; and (b) how the trading proceeds were allegedly appropriated to finance its total investment in associated companies. Despite its reliance on the application of the Clayton's rule, the Appellant has not conducted any Clayton's case type of tracing process to support its claim that the outflow of funds to finance its investments in associated companies had subsequently been replaced by the funds derived from the sale proceeds of goods. The analysis of the sources and application of funds submitted by the Appellant [B1, page 169] contradicts with its own claims. According to this analysis, the funds sourced from the sales receipts during the years of assessment 1998/99 to 2000/01 were applied to the payment of purchases and other business costs, giving of credit to trade debtors and payment to trade creditors. There is nothing to indicate that the inflow of funds derived from the sale proceeds of goods were used to finance the Appellant's investments in associated companies.

35. The Appellant borrowed two loans totalling $8 million from Company B in October 1993. The loans remained unpaid until 28 February 2004 when a partial repayment of $200,000 was made. According to the directors' report for the years ended 31 March 1996 to 1998, the Appellant's principal activity was investment [R1, page 38]. According to the balance sheets as at

31 March 1996 to 1998, the great bulk of the Appellant's assets were the share capital invested in and various loans made to the associated companies. There is no income or turnover shown in the profit and loss accounts for the same periods. There is no evidence to show that the investments held by the Appellant were for the purpose of producing chargeable profits. It is also apparent that the loans from Company B were used to finance the holding of these investments. Accordingly, the interest expenses and other expenses incurred by the Appellant during those years of assessment could not be said to have been for the production of chargeable profits and should therefore be wholly disallowed by virtue of sections 16(1) and 17(1)(b) of the IRO. It follows that the losses sustained by the Appellant could not be carried forward for set off against its future assessable profits.

36. Likewise, according to the balance sheets as at 31 March 1999 to 2001, the great bulk of the Appellant's assets were still the investments in associated companies which did not produce any chargeable profits. The total amounts of share capital and non-interest bearing current accounts in associated companies held by the Appellant were $16,180,000, $15,063,800 and $15,063,800 as at 31 March 1999, 2000 and 2001 respectively, whereas the interest-free shareholder's loan for the corresponding dates stood at $6,948,052, $6,147,634and $6,282,518 only [B1, page 72, 91 and 110]. The amounts of investment in associated companies fell far short of the amounts of the shareholder's loan. There were no retained earnings. On the contrary, the deficiency in shareholders' funds amounted to $1,125,532, $1,735,464 and $2,566,109 respectively [B1, page 72, 91 and 110]. It is clear that the investments in associated companies must have been partly financed by the loans from Company B. Accordingly, part of the interest expenses that was attributable to the investments in associated companies could not be said to have been incurred in the production of chargeable profits and should be disallowed.

37. By virtue of section 16(1) and on the authority of the case of So Kai Tong, the Commissioner has to ascertain the extent to which the interest expenses were incurred for the production of chargeable profits. Regard is made to rule 2A of the IRR and the apportionment should be made on such basis as is most reasonable and appropriate in the circumstances of the case. Throughout the periods concerned, there had been movements in the Appellant's investment in associated companies. There is no sufficient information showing how the borrowed funds were specifically redeployed as a result of these investment changes. The Revenue submits that the only practicable basis, which is also reasonable and appropriate in the present context, for apportioning the interest expenses is to use the formula adopted in the determination which was based on the assets held by the taxpayer at the year-end [D68/87 and D66/88 followed].

38. The Appellant also stated, as one of his grounds of appeal, that the Deputy Commissioner had failed to determine the 'objection' against the 2004/05 'assessment'. It can be seen from the correspondence between the Appellant and the assessor that all along the Revenue did not accept that there was an assessment made for the year of assessment 2004/05 to which the Appellant might object [R1, pages 53-55, 57, 59-65]. As such, there is no determination for the year of assessment 2004/05. In any event, the Appellant has not established how the alleged failure

of the Commissioner could have affected his expenses claims for the years of assessment from 1995/96 to 2000/01.

Conclusion

39. The Revenue submits that the Appellant has failed to discharge the onus of proving that the profits tax assessments for the years of assessment 1998/99, 1999/2000, 2002/03 and 2003/04 are incorrect or excessive.

40. Accordingly, it is respectfully submitted that this appeal should be dismissed and the assessments be confirmed.