Case No. D49/90

Profits tax – whether certain expenditure was wholly and exclusively incurred in the production of chargeable profits.

Panel: Howard F G Hobson (chairman), Walter Chan Kar Lok and Douglas C Oxley.

Dates of hearing: 22, 23 and 24 October 1990.
Date of decision: 12 December 1990.

The taxpayer was a company which purchased a building which it mortgaged to a bank to secure general banking facilities. It was the intention of the taxpayer to sell most of the units in the building which it had bought. The taxpayer made loans to related companies which were interest fee. The taxpayer sought in its tax return to deduct from its taxable income the full amount of the interest paid on the bank loan which it had obtained. The assessor refused to allow all of the interest to be deducted on the ground that the bank loan had been used in part to make the interest fee loans to related companies and not to earn profits. The taxpayer appealed to the Board of Review.

Held:

The determination of the Commissioner was upheld on the ground that the loans made were not made to earn income for the taxpayer.

Appeal dismissed.

S P Barns for the Commissioner of Inland Revenue.
Taxpayer represented by its director.

Decision:

The Taxpayer company ('the Taxpayer') was assessed to profits tax for the years of assessment 1986/87 and 1987/88. It appealed against the assessments, as determined by the Commissioner of Inland Revenue, on the ground that certain disallowed sums constituted expenditure wholly and exclusively incurred in the production of chargeable profits.

1. Background

The following undisputed facts are derived largely from the determination.

1.1 The Taxpayer was incorporated in 1982 and it purchased a property known as A Building ('the building') in B Place from C Limited ('C Ltd') for $69,364,049. On the same day the Taxpayer mortgaged the building to a bank ('the bank') to secure general banking facilities of $66,000,000.

1.2 The building was purchased with the intention of selling 133 of the 139 units comprised in the purchase: six units on the first floor were to be retained.

1.3 At all relevant times:

(a) The Taxpayer's fully paid up share capital was made up of 100,000 shares of $1 each which were beneficially owned, by the following:

Mr X	60,000 shares
His wife (Mrs X)	20,000 shares
The bank	20,000 shares

(b) the directors were Mr X, Mrs X and two nominees of the bank.

1.4 The Taxpayer having failed to lodge a tax return, the assessor issued an estimated profits tax assessment of $4,000,000 for 1986/87 on 20 October 1987.

1.5 On 5 November 1987 the Taxpayer objected against this assessment and lodged its 1986/87 profits tax return disclosing assessable profits of $2,040,364. The Taxpayer's account for the year ended 31 December 1986 accompanying the return showed the Taxpayer had incurred bank interest of $1,397,675.66 but had made interest free loans of $5,780,429 to companies owned by Mr X (related companies).

1.6 On 28 September 1988 the Taxpayer lodged its return for 1987/88 showing a loss of $1,741,306 for the basis period year ended 31 December 1987. The loss was arrived at after deducting bank interest incurred of 579,371 and $5,783,789 written off as bad debts of the related companies.

1.7 On 4 November 1988 the assessor raised a profits tax assessment with respect to the 1987/88 return as follows:

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Loss per return	(1,741,306)
Less: Amount due form related companies written off	5,783,789
Assessable profits	$4,042,483
	========
Tax payable thereon	$727,646
	=======

The $5,783,789 was written back pursuant to section 17(1)(c) of the Inland Revenue Ordinance ('IRO').

1.8 The Taxpayer objected against the 1987/88 profits tax assessment claiming that the loan written off was, in the Taxpayer's words, '… and expenditure wholly and exclusively for the production of chargeable profits for the Taxpayer'.

1.9 In his determination the Commissioner rejected the Taxpayer's objections and increased the 1986/87 assessment by $433,320 and the 1987/88 assessment by $241,644, being those portions of the bank interest which the Commissioner considering related to the interest free loans to related companies, such loans have not been incurred in the production of the Taxpayer's profits (see section 16(2) IRO and rule 2A(2) of the Inland Revenue Rules).

2. Evidence

Mr X represented the Taxpayer at the hearing and also gave evidence on oath to the following effect.

He owned a manufacturing company founded in 1980 (D Company) which operated from a factory in Hong Kong. In 1981 it had a turnover of $6,000,000 and three hundred employees. By early 1982 D Company, which had monthly overheads of $2,000,000, was severely affected by the then world wide recession. Mr X tried to borrow from the bank to keep D Company going but the bank considered that he was unwise to try to do so, instead it was suggested he should look for something bigger and more viable. In mid-1982, Mr X saw the building advertised for sale by C Ltd. He approached Mr Y (known personally to him) of C Ltd since it appeared that the latter was having difficulty in getting the price it wanted. Mr Y expressed a willingness to sell for $67,300,000 which Mr X told us was a bargain because it was well below C Ltd's original expectation of $90,000,000. Mr X then approached the bank which agreed to let the Taxpayer have banking facilities of about $66,500,000 and (through nominees) to put up $20,000 by way of share capital into the Taxpayer. Mr X himself agreed to lend $3,500,000 to the Taxpayer.

The purchase was effected in September 1982. Mr X believed that all the 133 units could be sold within six months at a substantial profit. At first sales went well but the dramatic loss of confidence which affected Hong Kong following the British Prime Minister's visit to Beijing in October 1982 resulted in most buyers reneging on their contracts, though about ten did proceed to completion.

By then Mr X, as the main shareholder and guarantor of D Company, faced sizable cash demands from D Company's creditors, as well as receiving writs and threats of bankruptcy. Of the two major activities Mr X reached the conclusion that D Company would never return to profit whereas he was optimistic for the outcome of the Sino-British negotiations and that real estate prices would once again rise and he would make $10,000,000 profit. Believing, he said, that it was neither in the interests of the Taxpayer, nor of the bank as the mortgagee of the building, that he should be made bankrupt and since the Taxpayer was not obliged to make any given principal repayments to the bank out of the proceeds of sale of units (which proceeds were received in the first place by his own wholly owned consultancy company (E Company) which acted as agent for the Taxpayer) he used such amounts of these proceeds and building management fees as were surplus after meeting or allowing for the bank's interest charges to meet the demands of D Company's creditors during the years 1982, 1983 and 1984. He embarked on this tactic without the knowledge of the bank or its nominee directors.

He maintained before us that the bank's nominees left the conduct of the Taxpayer entirely in his hands - at least until Jul 1983 – and maintained that the bank's approval was unnecessary because he was the majority shareholder and could therefore overrule the objections of the banks' nominees. The bank however called for a meeting in or about July 1983. Mr X had his accounts people draw up a 'brief financial statement' showing a figure of $4,246,403 as 'directors' drawing and unallocated expenses'. Mr X was surprised at the full extent of this figure. He had not, he said, kept track of the amounts of the cheques paid to D Company's creditors from the Taxpayer's resources, indeed the cheques had not been booked in the Taxpayer's accounts. He said though the bank's officials were angry they agreed, reluctantly, to allow him to satisfy D Company's creditors to enable him to close down D Company's activities in a fashion which would not bring him into disrepute and thereby reflect poorly on his attempts at selling the building's remaining units.

Mr X addressed us at considerable length on his own remarkable capabilities. He made the point that whereas C Ltd had been unsuccessful in marketing the units (they had only sold $1,000,000 of units by the time the Taxpayer bought the building), on the other hand, he managed to sell $50,000,000 of units within one month of the Taxpayer's purchase of the building. (Most of these sales were frustrated by the 1982 October confidence crisis whereupon the Taxpayer forfeited their deposits.) Mr X said that at the time that he diverted the surpluses he was under such pressure that he gave no thought as to how they should be categorized; his mind was directed to placating the more aggressive of D Company's creditors in order to buy time until property prices rose again. He suggested that the unique quality of his charisma is borne out (objectively) by the willingness of the bank to advance 95% of the purchase price for the building and to take a 20% equity and ultimately the bank conceding that his actions in diverting the surpluses were justified.

Mr X acknowledged that in the event the diverted monies were described in the Taxpayer's accounts as loans due from E Company but said that was merely a temporary expedient until such time as he resolved the he had told D Company's creditors (including bankers) that there was a party, whose name he did not disclose to them, who was willing to lend him monies to sort out his affairs. Mr X said he told them this to avoid their believing that he had a source of earnings which would lead them to press for immediate payment even harder (and presumably in full).

In 1988 Mr X bought the bank's 20% of the Taxpayer for $3,800,000 which was based on a surveyor's valuation of the building – (presumably the then remaining units). Mr X said the bank at that time said they had made the right decision to allow him to draw on the Taxpayer to pay off D Company's creditors.

In cross-examination Mr X mentioned that he had given the bank an unlimited guarantee with respect to the Taxpayer's banking facilities and that C Ltd and Mr X's father-in-law (a person of some considerable wealth) had given guarantees limited to 20% of any loss the bank might suffer. Mr X told us that C Ltd had required a fee of $5,000,000 for their guarantee (which fee was evidenced by a post dated cheque drawn on the Taxpayer) payable if the Taxpayer made a profit. Mr C did not advise the bank's nominee directors of this arrangement because 'the bank had squeezed the price of the building down' moreover if the Taxpayer made a profit then the bank would be happy to pay the fee. Nor did Mr X tell the Taxpayer's auditors of the fee arrangement. Mr X said it was not shown in the Taxpayer's accounts as a liability because it was contingent and might never materialize. He said the bank never called on any guarantor. In 1988 Mr X renegotiated C Ltd's fee down to $2,500,000 payable (interest fee) by three instalments. Mr X remembered that in response to the Taxpayer's auditor's standard enquiry E Company acknowledged that the amounts shown in the Taxpayer's accounts as loans due by E Company were correct.

When asked why in the Taxpayer's 1987 accounts dated 22 August1987 (with must be an error for 1988) the Taxpayer had shown the diverted surpluses then totalling $5,783,789, under the heading 'due from related companies' as written off, he said he had written a note to the auditor to say that the category in which this amount was shown (that is, an asset in the balance sheet) was dependent on the results of the objection to the tax assessment and if it went in the Taxpayer's favour the accounts could be adjusted to show the amount as expenditure (in the profit and loss account).

In the course of cross-examination Mr X maintained that not only should the $5,783,789 be treated as expenditure but also such of the bank interest incurred by the Taxpayer on that amount. He was asked why no person from the bank was going to testify before the Board. Mr X said he did not want trouble the bank because it was still owed money by the Taxpayer.

Mr X acknowledged that there had been a shift of emphasis since his original objection to the 1986/87 estimated assessment. Originally he had asserted that the $5,000,000 odd diverted surpluses were derived from loans from the bank but were on-lent to D Company free of interest, and since such on-lendings were for the benefit of the Taxpayer (to avoid Mr X's bankruptcy and thereby preserve the integrity of the Taxpayer) the interest charged by the bank to the Taxpayer on as much of the bank borrowings as was on-lent should be deductible as an interest expense when calculating the Taxpayer's 1986/87 taxable profits. He said he put that argument forward in haste on the 5 November 1987 as the Taxpayer only had a month to express its objection to the 20 October 1987 assessment, hence he had no time to think what actually happened and upon what grounds' to defend the tax' that is, the estimated assessment. He showed the diverted surpluses in the Taxpayer's financial statements as loans to keep up the pretence with D Company's creditors. However when he reached a settlement with D Company's creditors in 1988 he felt free to explain to the assessors the true nature of the diverted surpluses.

3. The Taxpayer's submission

The Taxpayer's acknowledged that if the Board found that the diverted monies were loans then the Taxpayer's appeal filed altogether since they would constitute capital rather than trading loans. Mr X did not therefore address us on the question of whether the diverted monies, qua written off loans, constituted lost capital or bad trading (sections 16(1)(2) and 17(1) (c) of the IRO).

The crux of the Taxpayer's contention is that the diverted monies and bank interest incurred by the Taxpayer on that amount of the bank borrowings as matched the diverted surpluses were expenses wholly and exclusively incurred in the production of the taxpayer's profits. In this respect Mr X argued that as there was not the slightest chance of D Company repaying the Taxpayer the diverted surpluses could not properly be described as loans.

4. Conclusion

Having heard Mr X at great length we consider that he was not a witness whose testimony should be relied upon in the instant case. We reached this conclusion despite the impression he wished to give of frankness, such as his candid admission that he misled D Company's creditors; we are left with the distinct feeling that so far as his testimony is concerned truth altered, chameleon-like, to suit its surroundings. He admitted that the Taxpayer's submission that the diverted monies constituted expenses occurred to him some months after the objection to the 1986/87 estimate was lodge (and, it occurs to us, possibly after it became clear that the diverted monies, if treated as loans, were not deductible from the Taxpayer's taxable profits).

The following highlight only some of Mr X's testimony which influenced us in our unfavourable impression.

He did not consult the bank before diverting the Taxpayer's surplus monies: his explanation that, in effect, he saw nothing wrong in his action is unacceptable, for if – as he argued – he was quite entitled to act as he did then why did he not get the bank's approval and why should the bank be angry when they discovered the extent of the diversions?

Mr X's claim that he could overrule the bank's nominees because of his majority shareholding ignores the ability of the bank, which held two valuable guarantees together covering 40% of any losses, to call in the general banking facilities at any time for any reason.

Mr X said the Taxpayer's financial statements showed the diverted monies as loans because D Company's banking creditors might wish to see them. If indeed the monies were not intended to be loans then the statements themselves did not give a true and fair view of the state of affairs of the Taxpayer as required by section 123 of the Companies Ordinance – as this was done with the intention to mislead the default could be viewed as a grave one, and as the Taxpayer's books of account did not properly reflect the diversions there was a prima facie breach of section 121 of the same Ordinance.

Mr X said he had insufficient time to decide on his 'defence to the tax' when the 1986/87 assessment was received. This is not credible: diversions, according to Mr X, had been going on since 1982 therefore at least four profits tax returns and assessments were made prior to the 1986/87 estimated assessment in November 1987. It is clear from the financial statements for the year ended 31 December 1986 that diverted surpluses of about $5,000,000 existed then and that the Taxpayer made taxable profits in the year ended 31 December 1985.

Mr X said that D Company was incapable of repaying the diverted monies and supported that assertion with an extract from an accountant's report on D Company done on behalf of another bank consequently it would be a misnomer to describe the monies as 'loans'. Nevertheless without direct and unequivocal corroboration from the bank itself we cannot believe that the bank if aware of the diversions in 1982 would have agreed to their not being treated as loans, however unlikely their recovery, but instead being treated as expenses. In this regard the bank had two nominees on the Taxpayer's board, those nominees approved the Taxpayer's financial statements in which the diverted surpluses were shown in the balance sheet as due from related companies – not expenses in the profit and loss accounts. In the absence of any testimony from the bank's nominees as to why, having agreed (if such was the case) with Mr X to treat the diverted surpluses as expenses, they should allow the accounts to improperly show them as assets thereby increasing the apparent asset value of the Taxpayer Mr X's testimony must be rejected. Mr X's explanation for the absence of any witness from the bank is quite unacceptable bearing in mind that the Taxpayer is faced with tax for the two years under review totalling $1,228,773. We think Mr X's failure to acquaint the bank's nominees and seemingly the Taxpayer's auditors of his arrangement concerning C Ltd's fee cannot lightly be ignored when assessing Mr X's integrity. We therefore reject Mr X's testimony on the nature of the diverted surpluses. Though it would perhaps suffice merely to rule that the Taxpayer has failed to satisfy us that the two assessments are excessive or incorrect (section 68(4) IRO), we consider that there is ample evidence that the surplus monies were loans and that no justification exists for treating them as trading loans. Accordingly we find as a matter of fact that the diverted surpluses were made by way of loans which were capital in nature.

Mr Barns referred us to various authorities and judicial reports bearing upon what expenses are properly deductible. Having reached the conclusion that the diverted surpluses were loans and since the Taxpayer's representative conceded before us that in such event its appeal would fail we need not deal with Mr Barns' submissions. In passing however we might add that had there been any reasonable evidence entitling us to treat the diverted surpluses as expenses we would undoubtedly have concluded they had not been incurred in the production of taxable profits.

This appeal is therefore dismissed. As a corollary to our finding we recommend to the Commissioner that the Taxpayer's assessments for the tax years preceding 1986/87 (or such of them as are not affected by section 60(1) IRO) be re-examined to see whether bank interest was also deducted from taxable profits for those years and if so whether there are grounds for apportionment under rule 2A(2) of the Inland Revenue Rules.