INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D49/95

Profits tax – application under section 70A of the Inland Revenue Ordinance.

Panel: Andrew J Halkyard (chairman), Christopher Henry Sherrin and Edward Chow Kam Wah.

Date of hearing: 27 June 1995.
Date of decision: 18 August 1995.

The taxpayer appealed against a decision of the Commissioner to correct assessments under section 70A of the Inland Revenue Ordinance. One year in question had already been determined by the High Court. The other years were similar and/or not supported by evidence.

Held:

The appeal was dismissed and costs of HK$5,000 awarded.

Appeal dismissed with $5,000 awarded being costs of the Board.

Cases referred to:

D40/91, IRBRD, vol 6, 159
Mortimer J IRA No 6 of 1991
Sun Yau Investment Co Ltd v CIR [1983] 2 HKTC 17
D7/89, IRBRD, vol 4, 185
D66/88, IRBRD, vol 4, 85

H Bale for the Commissioner of Inland Revenue.
Anthony P Fahy of Messrs A P Fahy & Co for the taxpayer.

Decision:

The Taxpayer has appealed against the decision of the Commissioner to disallow its objection to the profits tax assessment for the year of assessment 1991/92. The Taxpayer has also appealed against the Commissioner's refusal to correct, under section 70A of the Inland Revenue Ordinance ('the IRO'), the profits tax assessments for the years of assessment 1986/87 to 1990/91 inclusive. The Taxpayer claims that the various assessments are not in accordance with the amounts shown in its audited accounts and

profits tax returns and that it was a mistake to disallow interest expenditure incurred for producing its assessable profits.

On the basis of the evidence produced before the Board, we find the following facts.

The facts

1. The Taxpayer failed to submit profits tax returns for the years of assessment 1986/87 to 1991/92 inclusive within the time limit stipulated on the returns as extended by the Commissioner. On various dates, the assessor then raised the following estimated profits tax assessments on the Taxpayer under section 59(3) of the IRO:

Year of Assessment	Estimated assessable profits	Tax payable thereon
	$	$
1986/87	250,000	46,250
1987/88	300,000	54,000
1988/89	400,000	68,000
1989/90	440,000	72,600
1990/91	260,000	42,900
1991/92	950,000	156,750

2. On various dates, the Taxpayer, through Firm X ('the Representative') lodged valid objections against the assessments for the years of assessment 1986/87, 1987/88 and 1989/90. In the profits tax returns for those years of assessment, assessable profits were disclosed as follows:

Year of Assessment	Assessable profits per return
	$
1986/87	233,753
1987/88	246,769
1989/90	231,859

In the tax computation submitted with the profits tax return for each of these years of assessment, the Taxpayer disclaimed, as a non-deductible expense, the following amounts designated as 'bank interest applicable to investments':

Year of assessment	Amount disclaimed in tax computation
	$
1986/87	28,552
1987/88	25,291

1989/90	45,951

3. The assessor revised the estimated assessments for the years of assessment 1986/87, 1987/88 and 1989/90 referred to in fact 1 in accordance with the assessable profits disclosed by the Taxpayer in fact 2. An assessor's note to each revised assessment stated that the assessable profits were 'revised per return' under section 64(3).

4. On 19 December 1989, the Taxpayer objected to the estimated assessment for the year of assessment 1988/89 referred to in fact 1. The objection was not accompanied by a profits tax return. It was not, therefore, accepted by the assessor as a valid objection in accordance with section 64(1) of the IRO.

5. On 5 March 1990, the Taxpayer filed its profits tax return for the year of assessment 1988/89 together with audited accounts and tax computation. On 12 April 1990, the Representative submitted an application under section 70A requesting the assessor to correct the estimated assessment for the year of assessment 1988/89 on the ground that the return or documents submitted in relation thereto contained errors or omissions. On 4 May 1990, the assessor issued to the Taxpayer a notice of refusal to correct the assessment for the year of assessment 1988/89 under section 70A. The Taxpayer objected to the assessor's refusal. The Commissioner confirmed the notice of refusal. The Taxpayer appealed to the Board of Review against the Commissioner's decision. The appeal was heard and dismissed by the Board of Review (D40/91, IRBRD, vol 6, 159). The Taxpayer then appealed to the High Court which dismissed the appeal (per Mortimer J IRA No 6 of 1991).

6. The Taxpayer did not object to the estimated assessment for the year of assessment 1990/91 referred to in fact 1. In the continued absence of a profits tax return, on 27 December 1991 the assessor raised the following estimated additional profits tax assessment for the year of assessment 1990/91 on the Taxpayer:

Additional estimated assessable profits	$600,000
Tax payable thereon	$99,000

7. By a letter dated 3 February 1992, the Representative on behalf of the Taxpayer objected to the estimated additional assessment for the year of assessment 1990/91 set out at fact 6. Although the objection was submitted together with a profits tax return for the year of assessment 1990/91, it was not received by the Commissioner within one month after the date of the notice of assessment. It was not, therefore, accepted by the assessor as a valid objection under section 64(1).

8. By a letter dated 3 September 1992, the Representative on behalf of the Taxpayer lodged a valid objection to the estimated assessment for the year of assessment 1991/92 set out at fact 1 on the basis that the assessment was estimated and 'not in accordance with the return'. In the Taxpayer's profits tax return for the year of assessment 1991/92, submitted in support of the objection, assessable profits were disclosed of $57,407.

9. The audited accounts for the Taxpayer for the year ended 31 December 1991, which related to its profits tax return for the year of assessment 1991/92, disclosed among other things the following particulars:

Balance Sheet as at 31 December 1991

	$
Investment in Firm A	290,000
Investment in Firm B	999,480
Total assets	3,839,079

Profit and Loss Account for the year ended 31 December 1991

	$
Financial expenses: bank interest and charges	155,022

In the profits tax computation which related to its profits tax return for the year of assessment 1991/92, the Taxpayer proposed to disclaim, as a non-deductible expense, an amount of $63,470 designated as 'bank interest applicable to investments'. This amount was calculated as follows:

$$\frac{300{,}000 + 290{,}000}{1{,}429{,}933 + 13{,}610 - 2{,}500} \times \$155{,}022$$

10. On 16 November 1992, the assessor wrote to the Taxpayer and queried the computation of bank interest disclaimed (that is $63,470) in the profits tax computation set out at fact 9. On 30 November 1992, the Representative responded by contending that the expense should be an allowable deduction because the whole amount (that is, $155,022) was attributable to a mortgage secured on the Taxpayer's premises in order to earn rental income. The Representative then requested that the portion of interest expenses ascribed to investments previously adjusted in the Taxpayer's tax computations should also be corrected. In the course of his submissions the Representative stated:

> '[The Taxpayer] unfortunately invested in a loss making company [Firm B], and the $290,000 + $999,480 or $1,289,480 was the reason for our apportionment of interest expenses. A recent valuation of the shares in [Firm B] … shows the valuation of the shares at $19.25 below par as at 31 March 1990 and $14.365 below par as at 10 November 1984.'

11. The assessor accepted the Representative's letter of 30 November 1992 as an application under section 70A to correct the Taxpayer's profits tax assessments for the years of assessment 1986/87 to 1990/91 inclusive. However, the assessor was not satisfied that the profits tax charged for those years of assessment was excessive by virtue of errors or omissions as stipulated in section 70A. By notices dated 28 July 1993 and 7 September

1993 the assessor notified the Taxpayer of the refusal to correct the Taxpayer's profits tax assessments under section 70A.

12. The Taxpayer objected to the assessor's notice of refusal to correct the profits tax assessments for the years of assessment 1986/87 to 1990/91 inclusive under section 70A in the following terms:

> 'The errors in question are in connection with our disallowance of bank interest and charges which we incorrectly apportioned to a worthless asset on the balance sheet … The interest should have been claimed in full by us in full without any apportionment … [because] the whole amount of the interest is attributable to the mortgage, secured on the [Taxpayer's] premises in order to earn rental income [and] … the $290,000 plus $999,480 are not net assets; for [Firm B] shares they represented had fallen below par.'

13. In his determination dated 23 November 1994, the Commissioner confirmed the assessor's refusal to correct the Taxpayer's profits tax assessments for the years of assessment 1986/87 to 1990/91 inclusive. The determination also confirmed the assessor's proposal that the Taxpayer's profits tax assessment for the year of assessment 1991/92 should be revised as follows:

Profits per return (fact 8 refers)	$57,407
Less: Bank interest disallowed in tax computation (fact 9 refers)	63,470
	(6,063)
Add: Bank interest attributable to non-income producing assets	52,069*
Revised assessable profits	46,006

* Calculated as follows $155,022 × 1,289,480 (Investments) / 3,839,079 (Total Assets)

14. On 19 December 1994, the Taxpayer appealed against the Commissioner's determination to the Board of Review.

Oral evidence adduced for the Taxpayer

The Representative called one witness on behalf of the Taxpayer, Mr Y. At all relevant times he was an employee of the Taxpayer. In response to a request from the Representative, Mr Y summarised his evidence as follows:

> 'In working for [the Taxpayer] for ten years, I can conclude that the Taxpayer may not be losing too much money. But Firm B [see fact 9] is definitely losing money [as its expenses, particularly labour costs, are higher than the income it receives from its business of cleaning drains].'

Mr Y became an employee of Firm B in 1994. Even assuming, at this juncture, that the financial position of Firm B was relevant to this appeal, Mr Y did not, and was in no position to, provide any evidence on this matter during any of the period relevant to this appeal, that is during the six year period ended 31 December 1991. Mr Y's evidence could not, therefore, assist us.

Documents submitted to the Board by the Taxpayer

Before and during the course of the Board hearing the Representative submitted five bundles of documents for the Board's perusal. Many of these documents related to the affairs of other companies and other persons for whom the Representative acted. They were not in any way relevant to the issues before the Board. Where the documents did relate to the affairs of the Taxpayer, they were, to a very large extent, concerned with different years of assessment and different assessments from those before the Board. We found it very difficult to place any weight on these documents.

Nevertheless we have examined all these documents closely. To the extent that they were relevant, we have endeavoured to incorporate them in the facts found by us. But even in this regard we were not assisted by the Representative who simply submitted the documents in bundles without ever explaining why they were produced and what, if any, significance he wished us to place on them. The documents were not indexed; they were not presented in any thematic or chronological order; they were occasionally submitted in multiple copies; and, with the exception of several irrelevant documents submitted by Mr Y relating to Firm B, none was adduced by a witness who would have been subject to cross-examination. Accordingly, except to the extent that the documents speak for themselves and contain verifiable facts, the Board was not assisted by them.

The Taxpayer's contentions

During the course of the hearing the Representative reiterated the statements made in the notice of appeal. The Representative contended:

1. Generally, all the assessments in dispute were wrong because they were not in accordance with the Taxpayer's profits tax returns;

2. Specifically, the Commissioner was wrong in refusing to allow all the interest payments made to the bank as allowable deductions; and

3. The lifespan of the profits tax returns and assessments is two years and therefore valid objections should have been admitted for all years in dispute because the Taxpayer's profits tax returns had all been lodged within a two year period.

The Representative also raised many other matters. He commenced with a condemnation of the whole estimated assessment process, illustrated this with numerous examples of the Commissioner's treatment of taxpayers other than the Taxpayer (but including himself), and finished with a rhetorical question as to whether it was possible on 1 July 1997 to apply to the Hong Kong SAR Government for a refund of taxes paid in advance

referable to the period following the change in sovereignty. The Board was not assisted whatsoever by these oral submissions. The only point to emerge clearly therefrom was that, despite numerous opportunities, the Representative failed to clarify or even deal with any of the issues before the Board. In particular, he avoided all but the merest mention of any facts relevant to this appeal and the issues to be determined by us.

The issues before the Board

The issues for decision by the Board are:

1. Whether the profits tax assessments raised on the Taxpayer for the years of assessment 1986/87 to 1990/91 inclusive can be corrected under section 70A;

2. Whether the bank interest and charges amounting to $155,022 incurred by the Taxpayer during the year of assessment 1991/92 are fully deductible in accordance with the provisions of section 16(1) of the IRO; and

3. Whether the Taxpayer is correct in its contention that the lifespan of the profits tax returns and assessments is two years and therefore valid objections should have been admitted for all years in dispute because the Taxpayer's profits tax returns had all been lodged within a two year period.

Statutory provisions

So far as relevant, section 70 provides that an assessment shall be final and conclusive for all purposes of the IRO as regards the amount of assessable profits where:

1. No valid objection or appeal has been lodged within the time limit prescribed in section 64(1);

2. The amount of the assessable profits has been agreed under section 64(3); or

3. The amount of the assessable profits has been determined on objection or appeal.

Section 70A, however, provides for the re-opening of an assessment, which is otherwise final and conclusive in terms of section 70, if it is established to the satisfaction of the assessor that the tax charged is excessive by reason of:

1. An error or omission in any return or statement submitted in respect thereof; or

2. Any arithmetical error or omission in the calculation of the amount of the assessable profits or in the amount of the tax charged.

So far as relevant, section 16(1)(a) allows a deduction for profits tax purposes for sums payable by way of interest upon any money borrowed for the purpose of producing assessable profits. Rule 2A(2) of the Inland Revenue Rules then provides, again so far as relevant, that where it is necessary to make an apportionment of any expense by reason of it

having been incurred not wholly and exclusively in the production of assessable profits, the apportionment shall be made on such basis as is most reasonable and appropriate in the circumstances of the case.

Reasons

In relation to the appeal for the year of assessment 1988/89, the High Court has already decided that there was no error or omission in terms of section 70A (fact 5 refers). The doctrine of res judicata dictates that we must not re-open this issue. In our view, the continuance by the Representative with full knowledge of this aspect of the appeal, which has been concluded by a superior court, virtually amounted to an abuse of process.

In relation to the appeal for the year of assessment 1990/91, the issue in dispute is exactly the same, except that it deals with a different year of assessment, as that previously decided by the Board in D40/91, IRBRD, vol 6, 159 and upheld by the High Court, per Mortimer J, in IRA No 6 of 1991. We are bound by the decision of the High Court. As the Taxpayer had not submitted a valid profits tax return when the assessment had become final for the purposes of section 70, it cannot be said that there was 'an error or omission in any return or statement submitted in respect thereof' in terms of section 70A (see also Sun Yau Investment Co Ltd v CIR [1983] 2 HKTC 17).

In relation to the appeal for the years of assessment 1986/87, 1987/88 and 1989/90, profits tax returns were submitted by the Taxpayer to validate the objections lodged against the estimated assessments raised (fact 2 refers). The estimated assessments were then revised in accordance with the returns submitted (fact 3 refers). In the absence of any argument from the Commissioner, we have assumed that this was an appropriate situation for the Taxpayer to make an application under section 70A. Nevertheless, it is trite to state that for an application under section 70A to succeed, there must be an error and evidence must be adduced of that error (see D7/89, IRBRD, vol 4, 185). In this case, the Taxpayer contends that the loan on which interest was charged was solely attributable to a mortgage secured on the Taxpayer's premises in order to earn rental income and therefore the interest was wrongly apportioned in its taxation computations (fact 2 refers).

After hearing the oral evidence and contentions for the Taxpayer and then reviewing the documents submitted by the Representative and the Commissioner, the Board concludes that there is simply no factual substratum before us to challenge in any way the determination of the Commissioner. The Representative has wholly failed to present any evidence whatsoever which would lead us to conclude that the contention set out in the previous paragraph is substantiated. At no stage during the Board hearing did the Representative refer us to any document or other evidence showing how the bank loan was applied. The documents produced to us provide no clear answer. We are simply left with the fact that for each year in dispute the Taxpayer in its tax computations disclaimed, as a non-deductible expense, amounts designated as 'bank interest applicable to investments' (fact 2 refers). There is nothing before us to show that this treatment was incorrect. In the event, apart from allegations made by the Representative, there is no evidence to support the contention that there was any error or omission in any return or statement submitted in respect thereof for the years of assessment subject to appeal.

The Representative also argued that the alleged errors arose because interest expenditure was wrongly apportioned to a worthless asset, that is the investment in Firm B. According to the Representative, the error lay in failing to claim the interest expense fully as a deduction in the Taxpayer's profits tax returns. This argument is misconceived. Even assuming that the shareholding in Firm B was worthless, and we make no conclusion in this regard, deductibility of interest expenditure first involves satisfying the requirements of section 16(1). Section 16(1)(a) provides, inter alia, that a deduction is allowable for interest payable upon money borrowed for the purpose of producing assessable profits. Writing down the value of an asset appearing in the balance sheet is simply an accounting entry. If an investment has been funded by way of loan, and that borrowing was not made for the purpose of producing assessable profits, the relevant interest incurred by the borrower cannot become deductible under section 16(1) simply because that investment becomes worthless. What is crucial for deductibility is that funds were borrowed for the purpose of producing assessable profits, and not that the value of the asset acquired with those funds has depreciated.

In relation to the appeal for the year of assessment 1991/92, the issue for our decision is whether any bank interest or charges were incurred to finance any non-profit producing assets and, if so, how the amount incurred for that purpose should be computed. For the reasons set out in the previous two paragraphs, we conclude that the Taxpayer has failed to support its claim that the interest expenditure in dispute is wholly attributable to financing the holding of a property for producing taxable rental profits. Accordingly, some apportionment of the interest expenditure must be made (compare fact 9). In the absence of evidence showing the use to which the bank loan was put and the subsequent movement of funds, we agree with the Commissioner that the method of apportionment set out at fact 13, which was adopted in D66/88, IRBRD, vol 4, 85, is reasonable and appropriate in accordance with rule 2A(2) of the Inland Revenue Rules.

The Representative also contended that the lifespan of the profits tax returns and assessments is two years and therefore valid objections should have been admitted for all years in dispute because the Taxpayer's profits tax returns had all been lodged within a two year period. The IRO contains no provision which supports this argument. In any event, the Taxpayer's recourse against the Commissioner refusing to admit an objection to an assessment is an application for judicial review, not an appeal under section 66.

For the reasons set out above, we reject the Taxpayer's claims in their entirely.

Before concluding, we note that the appeal relating to the year of assessment 1988/89 had already been determined by the High Court and yet was re-argued by the Representative without any reference to that decision; the appeal relating to the year of assessment 1990/91 raised precisely the same issue and was bound to fail; the appeal relating to the remaining years of assessment was conducted by the Representative without any evidential basis to support of contentions made on behalf of the Taxpayer. In these circumstances, we feel it entirely appropriate to order the Taxpayer under section 68(9) to pay as costs of the Board the sum of $5,000 which shall be added to the tax charged and recovered therewith.