

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D52/86

Board of Review:

Robert W. N. Wei, *Chairman*, Chan Siu-hung Tom and Joseph Ming Lai, *Members*.

27 January 1987.

Profits Tax—whether claim for deduction of interest allowable under Section 16(1)(a) of the Inland Revenue Ordinance—whether the loan transaction artificial within the meaning of Section 61 of the Inland Revenue Ordinance.

The Appellant was a corporation incorporated in Panama. At all material times the sole shareholders and controllers of the Appellant were L and his wife. L is a retired building surveyor and property management consultant. The Appellant set up a branch in Hong Kong and on 1 August 1980 commenced the business of project management with L as its employee. A series of transactions followed and consequently the Appellant became the owner of a flat and debtor to L and his wife to the extent of US\$500,000. Interest on the loan is claimed as expenses for two years.

The incorporation of the Appellant, the employment of L by the Appellant, the loan transaction and the sale and purchase of the flat were all part of a plan to provide a shelter for L against the exchange control and tax laws of Australia, where he intended to live in retirement (as he had in fact done) and also to take a tax advantage under the tax laws of Hong Kong in respect of the interest payable on the loan. There was also the advantage of an estate duty saving.

The question for the Board was whether the Appellant was entitled to deduct the two sums of Interest as expenses incurred in the production of assessable profits under Section 16(1) of the Inland Revenue Ordinance. Three issues were raised on this question:

- (1) whether the money was borrowed by the Appellant for purpose of producing its profits within the meaning of Section 16(1)(a) of the Inland Revenue Ordinance;
- (2) whether the loan transaction was artificial with the meaning of Section 61 of the Inland Revenue Ordinance and
- (3) whether the loan transaction should be disregarded following the principle established in *Furniss v. Dawson* [1984] STC 153.

Held:

The Appellant was entitled to deduct the two sums of interest as expenses incurred in the production of assessable profits under Section 16(1) of the Inland Revenue Ordinance.

Appeal allowed.

Cases referred to:

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CHINN v. Hochstrasser [1981] A.C. 533
C.I.R. v Douglas Henry Howe H.K.T.C. 936
Cridland v. FC of T [1977] 140 CLR 330
Eilbeck v. Rawling [1980] 2 All ER 12
Europa Oil (NZ) Ltd. v. IRC [No. 2] [1976] 1 All ER 503 PC
Floor v. Davis [1978] Ch 295
Furniss V. Dawson [1984] STC 153
I.R.C. v. Burmah Oil Co. Ltd. [1982] STC 30
I.R.C. v. Duke of Westminster [1936] AC 1
LAU v. FC of T [1984] 54 ALR 167
Mullens v. FC of T [1976] 153 CLR 290
Oakey Abattoir v. FC of T [1984] 55 ALR 291
Patcorp Investments Ltd. v. FC of T [1976] 140 CLR 247
Products LDG Products v. The Queen [1976] 76 DTC 6344 (FCA)
Queen v. Alberta and Southern Gas Co. Ltd. [1977] 77 DTC 5244
Queen v. Esskay Farms Ltd. [1975] 76 DTC 6010
Ramsay v. IRC [1982] AC 300
Seramco Ltd. v. Income Tax Commissioner [1977] AC 287
Stubart Investments Ltd. v. The Queen [1984] 84 DTC 6305

Luk Nai Man for the Commissioner of Inland Revenue.
David Flux of Peat Marwick & Mitchell for the Appellant.

Reasons:

Subject of Appeal

1. This is an appeal by GC, a corporation incorporated in Panama (the Taxpayer), against the Profits Tax Assessment for the years of assessment 1981/82 and 1982/83 as confirmed by the Commissioner of Inland Revenue.

Facts

2. Facts stated in paragraph 1 of the Determination of the Commissioner of Inland Revenue (the Determination) are agreed.

3.1 The Taxpayer called one witness, L. Having heard his evidence and taking into account the agreed facts, we find as follows.

3.2 L is a retired building surveyor and property management consultant. He retired in 1982. In November 1977 L and his wife purchased as joint tenants a flat (the flat) in Hong Kong for \$660,000. On 10 July 1980 the Taxpayer was incorporated in Panama. At all relevant times the sole shareholders and controllers of the Taxpayer were L and his wife. A branch of the Taxpayer was set up in Hong Kong and, on 1 August 1980, commenced the business of project management in Hong Kong with L as its employee. As L and his wife lived in the flat, the Taxpayer paid L as owner of the flat rent for the period from 1 September 1980 to 10 November 1980 to provide rent-free accommodation for L as

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employee. On 11 November 1980 the Taxpayer entered into an agreement with L and his wife to purchase the flat for US\$500,000 (Appendix B to the Determination). The purchase was financed by a loan of the same amount made by L and his wife to the Taxpayer under a loan agreement of the same date with provisions as to payment of interest at commercial rates and reduction or waiver of interest if parties should so agree in the future (Appendix A to the Determination). The loan transaction and the flat purchase were accomplished by a series of bank transfers taking place on 20 November 1980, when L obtained a loan of US \$500,000 from a bank. The funds were then transferred to the Taxpayer's current account in account with the same bank in New York. The Taxpayer immediately afterwards transferred the money back to L's current account, thus extinguishing the bank loan. The net result is that the Taxpayer became the owner of the flat and a debtor to L and his wife to the extent of US\$500,000. L and his wife continued to reside in the flat until about October 1982 when L retired, and the flat has been let for rental income since. Interest on the loan for the two years ended 31 July 1981 and 1982 amounted to \$348,266 and \$505,750 respectively, which appear in the balance sheets under the head "Loan interest payable". No actual payment of the interest has been made.

3.3 The incorporation of the Taxpayer, the employment of L by the Taxpayer, the loan transaction and the sale and purchase of the flat were all part of a plan to provide a shelter for L against the exchange control and tax laws of Australia, where he intended to live in retirement (as he has in fact done) and also to take a tax advantage under the tax laws of Hong Kong in respect of the interest payable on the loan. There was also the advantage of an estate duty saving.

Issues

4.1 The question for the Board is whether the Taxpayer is entitled to deduct these two sums of interest as expenses incurred in the production of assessable profits under Section 16(1) of the Inland Revenue Ordinance. Three issues were raised on this question:

- (1) whether the money was borrowed by the Taxpayer for the purpose of producing its profits within the meaning of Section 16(1)(a);
- (2) whether the loan transaction is artificial within the meaning of Section 61; and
- (3) whether the loan transaction should be disregarded following the principle established in *Furniss v. Dawson* [1984] STC 153.

Section 16(1)—Expenses Incurred in the Production of Assessable Profits

4.2 Mr. Luk for the Revenue contended that the money was borrowed not for the purpose of producing the Taxpayer's profits but for the saving of tax only by offsetting the interest as expenses against the Taxpayer's income. On the other hand, Mr. Flux for the Taxpayer argued that interest incurred in providing residential accommodation for an employee who generated income for the taxpayer was incurred for the production of

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assessable profits. Section 16(1), so far as relevant to this appeal, provides for the deduction of outgoings and expenses incurred in the production of profits, including: (a) sums payable by way of interest upon money borrowed for the purpose of producing such profits. Para. (a) being only an example of the deductible outgoings and expenses, its interpretation should in our view be governed by the opening words of Section 16(1). The key words for present purposes are “incurred in the production of assessable profits”. Similar enactments have been considered by the Privy Council. Section 111 of the Land and Income Tax Act 1954, as amended in 1968, of New Zealand provides for the deduction of “expenditure or loss incurred in the production of assessable income”. So far as deductible expenditure is concerned, the principle laid down in *Europa Oil (NZ) Ltd. v. IRC*. [No. 2] [1976] 1 ALLER 503 PC at 508 is in the following terms. “... it is not the economic result sought to be obtained by making the expenditure that is determinative of whether the expenditure is deductible or not; it is the legal rights enforceable by the taxpayer that he acquires in return for making it.” It is clear that conceptually this principle is based on the authority of *IRC v. Duke of Westminster* [1936] AC 1 which laid it down that “every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be.” (See *Europa Oil*, 506) The dictum of Lord Wilberforce in *IRC v. Europa Oil (NZ)* [No. 1] [1971] AC at p. 772 that “taxation by end result or economic equivalence is not what the section (Section 111) achieves” was affirmed in *Europa Oil (NZ) v. IRC* [No. 2] [1976] 1 ALLER at p. 509. We think the same principles should be applied in construing Section 16 (1) (a). The question for the purposes of the instant appeal may therefore be framed thus: was the tax advantage in terms of the interest being an allowable deduction a legally enforceable right obtained by the Taxpayer in return for incurring the interest? The answer must be no. The tax advantage was not obtained in return for incurring or agreeing to incur the interest which was payable to L and his wife, and there is no question of enforcing the tax advantage against them. The tax advantage was merely a fiscal result sought to be obtained by the Taxpayer in incurring the interest.

Section 61—Artificial Transaction

4.3.1 In *Seramco Ltd. v. Income Tax Commissioner* [1977] AC 287, their Lordships of the Privy Council cautioned against paraphrasing the word “artificial” and limited themselves to an examination of the agreement in question and the circumstances in which it was made and carried out, in order to see whether the particular transaction was properly described as “artificial” within the ordinary meaning of that word. (Ibid, 298) The key provisions of the agreement in question (an agreement for the sale of some shares in a limited company by the Elder family to trustees of a superannuation fund) were found to be unrealistic from a business point of view (ibid, 294). There was no genuine exercise by the trustees of the powers of investment of moneys standing to the credit of the fund because in fact they had no funds with which to make the purchase (ibid, 299), nor was there any genuine sale by the Elder family of their shares for a price payable by instalments accompanied by an option to re-purchase them, because it was an irresistible inference that it was never contemplated by the parties that the title to the shares would not be retransferred to the Elder family as soon as the first four instalments (out of a total of eight instalments)

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had been paid by the trustees. The cumulative effect of these features was that the transaction was properly described as an “artificial” transaction within the meaning of Section 10(1) of the Income Tax Law 1954 of Jamaica, which is similar in terms to Section 61 (ibid, 299). Having considered the terms of the loan agreement and the flat purchase agreement and the circumstances in which they were made and carried out, we are of the view that the loan transaction was not artificial within the meaning of Section 61. The mere fact that one of the purposes of the loan was to take a tax advantage does not make the transaction artificial. It is true that no assignment of the legal title to the flat has been made and therefore in a formal sense the purchase has not yet been completed. But in equity the Taxpayer is as much an owner as if the legal title had been assigned to it. In the event of a resale, the Taxpayer can follow the common practice by asking L and his wife to act as confirmors in the assignment. The reason for this practice is of course the saving of stamp duty which would otherwise have been payable on an assignment from L and his wife to the Taxpayer. However, that does not change the fact that the agreements were capable of being, and intended to be, carried out to the full and were in fact carried out to the full. In truth and in fact the Taxpayer is the owner of the flat which brings in rental income whilst L and his wife, who control the Taxpayer, reside in Australia. That is the way they have arranged their affairs. There is nothing artificial about it. “Every man is entitled if he can to order his affairs so as that the tax attaching under appropriate Acts is less than it otherwise would be.” (CIR v. Douglas Henry Howe HKTC 936, at 951 citing the Duke of Westminster case)

4.3.2 Furthermore, if the interest in question is an allowable deduction under Section 16(1)(a), as we think it is, Section 61 can have no application in any event. The tax advantage which is conferred by the former section cannot in our view be withdrawn by the latter. The courts in Australia have considered the applicability of Section 260 of the Income Tax Assessment Act, which, like our Section 61, is an anti-avoidance provision of general application which seeks to annul, inter alia, contracts and arrangements having the purpose or effect of avoiding any liability imposed by the Act. It was decided in *Mullens v. FC of T* (1976) 135 CLR 290 that even if a transaction has been entered into for the purpose of diminishing a taxpayer’s liability to tax by securing to the taxpayer a benefit or advantage conferred by a specific provision of the Income Tax Assessment Act, e.g. an allowable deduction, which but for the transaction would not have accrued to the taxpayer, the transaction will not be caught by s. 260 if it satisfies the provision in question. Stephen J says at 318, “So, too, if no question arises of a choice between two courses of conduct but, instead, the Act offers certain tax benefits to taxpayers who adopt a particular course of conduct, the adoption of that course does not establish any purpose or effect such as is described in s. 260.” In *Cridland v. FC of T* (1977) 140 CLR 330, it was held that the taxpayer was entitled to create a situation which attracted tax consequences for which the Act made specific provision. The validity of the transaction by means of which the situation was brought about was not affected by s. 260 merely because the tax consequences were advantageous to the taxpayer and he entered into the transaction deliberately to gain the advantage. We adopt the reasoning of these cases.

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4.3.3 The Canadian courts have followed similar reasoning in considering Section 137 of the Income Tax Act 1952 and its applicability to tax advantages. Section 137 provides in part: “In computing income for the purposes of this Act no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce the income.” “What the defendant has done has been [so] to order its affairs as to attract a lesser tax at a subsequent time as it is entitled to do The defendant has effected a tax advantage to itself as is its right and accordingly it is incongruous that that advantage should be construed as a “benefit” to the defendant within the meaning of s. 137(2).” (*The Queen v. Esskay Farms Ltd.* (1975), 76 DTC 6010 at p. 6018) In *Produits LDG Products v. The Queen* (1976) 76 DTC 6344 (FCA) at 6349, Pratte J says “There is nothing reprehensible in seeking to take advantage of a benefit allowed by the law. If a taxpayer has made an expenditure which, according to the Act, he may deduct when calculating his income, I do not see how the reason which prompted him to act can in itself make this expenditure non-deductible. I therefore believe that in the case at bar, there is no reason to apply s. 137(1).” To the same effect is the *Queen v. Alberta and Southern Gas Co. Ltd.* (1977) 77 DTC 5244 at 5249 where Jackett CJ says “.... a transaction which clearly falls within the object and spirit of [a given section of the Act] cannot be said to unduly or artificially reduce income merely because the taxpayer was influenced in deciding to enter into it by tax consideration.” All three cases were cited in *Stubart Investments Ltd. v. The Queen* (1984) 84 DTC 6305 at 6319.

Furniss v. Dawson—Business Purpose Test

4.4.1 In dealing with schemes for saving capital gains tax, the U.K. courts have developed a different approach to that adopted by Lord Tomlin in the *Westminster* case. The history of this change began with the case of *Floor v. Davis* [1978] Ch 295, continued with *Eilbeck v. Rawling* [1980] 2 ALLER 12 CA, *Chinn v. Hochstrasser* [1981] AC 533, *Ramsay v. IRC* [1982] AC 300, *IRC v. Burmah Oil Co. Ltd.* [1982] STC 30 and culminated in *Furniss v. Dawson* [1984] STC 153, where some of their Lordships in the House of Lords spoke about exorcizing the ghost of the *Westminster* case and freeing the courts from the shackles which have for so long been thought to be imposed on them by the *Westminster* case (per Lord Roskill at 157 and per Lord Bridge at 159). The principle is formulated by Lord Brightman at p. 166 in these terms. “First, there must be a preordained series of transactions or one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e., business) end Secondly, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax—not no business effect. If these two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end result.”

4.4.2 There is no anti-avoidance provision of general application in the U.K. income tax laws although there is piecemeal legislation covering particular classes of transactions, such as Section 460 of the Income and Corporation Taxes Act 1970 relating to transactions in securities. Nor is there any general anti-avoidance provision in the U.K. capital gains tax

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laws which began with the Finance Act 1965. As mentioned above the courts have developed an anti-avoidance doctrine of general application in this latter field. There is no precedent where the application of this doctrine was extended to an income tax avoidance case. Should it apply to such cases in Hong Kong? A similar question was considered in the Australian case of *Oakey Abattoir v. FC of T* (1984) 55 ALR 291, and was answered in the negative. “To import this principle into the realm of the operation of the Australian Income Tax Assessment Act is, (as Connolly J pointed out in *Lau v. FC of T* (1984) 54 ALR 167), by no means a self-evident process. It would seem that the decisions in *Ramsay* and *Furniss* proceed on the reasoning that, in the capital gains tax area, there is a doctrine of “economic equivalence”. Yet the Privy Council and the High Court of Australia have emphatically rejected taxation by “end result” or “economic equivalence” under the Australian Act (see *Mullens v. FC of T* (1976) 10 ALR 513 at 519)”. (Ibid, 298) The Full Court then turned to Section 260, which, as stated above, is an anti-avoidance provision of general application although couched in different terms to our Section 61. Their Lordships continues at 299, “In any event, even if *Ramsay* and *Furniss* decide that certain implications should be read into the United Kingdom Act, impliedly prohibiting tax avoidance or deferment, it does not follow that any such process of implication can simply be translated into very different Australian legislation. In this connection, the remarks of Gibbs J, as he then was, in *Patcorp Investments Ltd. v. FC of T* (1976) 140 CLR 247 at 292; 10 ALR 407 at 417, are pertinent: ‘However, the scheme of the English legislation is very different from that of the Australian Act. In particular the English legislation does not contain a provision like s. 260 of the Act which is aimed generally at tax avoidance. The presence of s. 260 makes it impossible to place upon other provisions of the Act a qualification which they do not express, for the purpose of inhibiting tax avoidance. In other words, it is not permissible to make an application which does what s. 260 fails to do in preventing the avoidance of tax. If it is suggested that a taxpayer has engaged in a device to secure a fiscal advantage, and the relevant provisions of the Act do not expressly deal with the matter, the case depends entirely upon s. 260.’ In our opinion, the *Ramsay* and *Furniss* principles should be perceived as no more than rules governing the statutory interpretation of the United Kingdom legislation for the taxation of capital gains. As such, they have no immediate impact upon the Australian Act.” In our view, the Hong Kong situation is comparable to that in Australia and the reasoning in the cases of *Patcorp Investments* and *Oakey Abattoir* should be adopted in considering whether the doctrine of *Furniss v. Dawson* has any application to Hong Kong income tax avoidance cases. On this reasoning, we are of the view that the doctrine has no application.

4.4.3 The Australian approach is echoed in the Canadian case of *Stuart Investments Ltd. v. The Queen*, supra, where the court was concerned with the question of validity of a tax reduction scheme. The Crown asked the court to find, without express statutory basis, that no transaction is valid in the income tax computation process that has not been entered into by the taxpayer for a valid business purpose. It relied on the business purpose test as evolved in the courts in the United Kingdom in the *Ramsay*, *Burmah Oil* and *Furniss v. Dawson* cases. The court rejected the test and held that the only law that could possibly apply was Section 137, supra, (which was in fact not relied on by the Crown). “It must be borne in mind that the United Kingdom tax statute, like the Internal Revenue Code of the

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United States under which the Helvering case was decided, contains no clause similar to our s. 137. Each of the English and American statutes had specific provisions barring dividend stripping, bond washing, land transactions and the like, but no general provision barring artificial transactions appears in the statutes.” (Ibid, 6316). “Whatever the source or explanation, measures such as s. 137 are instructions from Parliament to the community on the individual member’s liability for taxes, expressed in general terms. This instruction is, like the balance of the Act, introduced as well for the guidance of the courts in applying the scheme of the Act throughout the country.” (Ibid, 6321).

Decision

5. It follows therefore that this appeal is allowed and that the Profits Tax Assessments for the years of Assessment 1981/82 and 1982/83 are hereby annulled.