INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D55/95

Profits tax – deduction of taxable profits – company's deposit at bank which gone bankrupt – whether money revenue and not capital – whether loss expense or outgoing.

Panel: Ronny Tong Ka Wah QC (chairman), Barry J Buttifant and Victor R P Hughes.

Date of hearing: 8 June 1995.
Date of decision: 5 September 1995.

The taxpayer was a company and sought to deduct from its taxable income a sum deposit with the taxpayer's bank written off. This sum represented a debt owed by the bank which had gone bankrupt. The taxpayer sought to argue that the sum kept in the current account of the bank constituted part of the its revenue and not its capital, and that the loss suffered was really an expense or outgoing under section 16(1) of the Inland Revenue Ordinance (CAP. 112).

Held:

The debt was not a debt incurred in the trade of the taxpayer within the meaning of section 16(1)(d) of the Ordinance. Whether the loss in question was a deduction under section 16(1) depended on (a) whether the loss can really be said to be an outgoing or an expense; and (b) whether the loss was an outgoing or expense within the meaning of the Inland Revenue Ordinance. The debt written off was a loss and not an outgoing or expense.

Appeal dismissed.

Cases referred to:

Curtis v J & G Oldfield Limited [1925] 9 TC 319
CIR v County Shipping Company Limited [1990] 3 HKTC 267 CA
D67/91, IRBRD, vol 7, 227
Allen v Farquharson Brothers & Co [1932] 17 TC 59
Yates v Yates [1913] 33 NZLR 281
Lo & Lo v CIR [1984] 2 HKTC 34 PC
CIR v Mutual Investment Company Limited [1967] 1 AC 587
Wharf Properties Limited v CIR [1994] 1 HKRC 90-073
CIR v Swire Pacific Limited [1979] HKTC 1145
Ronpibon Tin N L v Federal Commissioner of Taxation [1949] 8 ATD 431
Strong & Co of Romsey Ltd v Woodifield [1906] AC 448, [1906] 5 TC 215

Bamford v ATA Advertising Ltd [1972] 48 TC 359
Hagart and Burn-Murdoch v CIR [1929] AC 386 HL
W A & F Rutherford v CIR [1939] 23 TC 8
Bury & Walkers v Phillips [1951] 32 TC 198

Ng Kwok Yin for the Commissioner of Inland Revenue.
Paul M P Chan of Messrs Paul M P Chan for the taxpayer.

Decision:

THE FACTS

1. The Taxpayer is an engineering company. Its main line of business is the provision of services relating to engineering works. In its profits tax return for the year of assessment 1991/92, the Taxpayer sought to deduct from its taxable profits a sum of $19,629 being deposit with the Taxpayer's bank ('the Bank') written off. This represents an amount owed by the Bank which had since gone bankrupt and in respect of which the Directors of the Taxpayer had considered there was very little chance of recovery. It was asserted before the Commissioner of Inland Revenue ('the Commissioner') from which this appeal was brought and indeed also before us that the amount lost represented money kept in the current account before the Bank's collapse as 'operating cash float of the Company.'

2. The Commissioner rejected the deduction on the ground that the loss represented a bad debt under section 16(1)(d) of the Inland Revenue Ordinance, Chapter 112 ('the Ordinance') and that in any event, the loss was neither an outgoing nor an expense but a loss of a capital nature.

THE CASE OF THE TAXPAYER

3. The case of the Taxpayer before us is as follows that:

(a) The Taxpayer had not sought and was content not to seek to argue that it was entitled to any deduction under section 16(1)(d) of the Ordinance that the loss was a bad debt;

(b) The Taxpayer was entitled to claim deduction under the 'general provision' of section 16(1) of the Ordinance;

(c) The money kept in the current account of the bank constituted part of the revenue of the Taxpayer and not its capital and that the loss suffered was really an expense or outgoing 'albeit quite unwillingly and hopefully non-recurrent, incurred in the ordinary course of business'.

THE CASE FOR THE REVENUE

4. The Revenue on the other hand, submitted that:

(a) The loss fell under the provision of section 16(1)(d) as being a bad debt and as such was not deductible under the 'general provision' of section 16(1);

(b) Further and alternatively, the loss was a loss of capital.

WHETHER MONEY LOST A BAD DEBT

5. The relevant part of section 16(1) is in these terms:

> *'In ascertaining the profits in respect of which a person is chargeable to tax … 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 … for any period, including –*
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> …
>
> *(d) bad debts incurred in any trade, business or profession, proved to the satisfaction of the assessor to have become bad during the basis period for the year of assessment, …:*
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> *Provided that –*
>
> *(i) deduction under this paragraph shall be limited to debts which were included as a trading receipt in ascertaining the profits, in respect of which the person claiming the deduction is chargeable to tax under this Part, of the period within which they arose, and debts in respect of money lent, in the ordinary course of business of lending of money within Hong Kong, by a person who carries on that business;*
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> *…'* ***(emphasis added)***

6. It will appear from the language of the subsection that in order to be caught by section 16(1)(d) the bad debt has to be:

(a) Incurred in the trade, business or profession of the Taxpayer in the production of profits in respect of which he is chargeable to tax;

(b) Debts which were included as a trading receipt in ascertaining the profits in respect of which the Taxpayer is chargeable to tax.

7. In this appeal, the Taxpayer accepted that the loss was *not* a bad debt. There is no evidence that the Taxpayer was engaged in the business of money lending. Whilst it is

asserted by the Taxpayer that the money represented 'circulating working fund' of and arising from trade debts received by the Taxpayer, there is no evidence that the money constituted a trading receipt *from* the Bank. Indeed, once the money was paid by the Taxpayer's trade debtors and received by the Taxpayer it ceased to be a trading debt but became part of the assets of the Taxpayer. When that money was then paid into the Taxpayer's account at the Bank it became a debt due from the Bank to the Taxpayer. That debt was neither a trading debt nor a trade receipt, still less a debt incurred in the trade or business of the Taxpayer 'in the production of profits in respect of which [the Taxpayer was] chargeable to tax.'

8. Rowlatt J in Curtis v J & G Oldfield Limited [1925] 9 TC 319 explained the meaning of the term 'bad debt' (at page 330) in this way:

> *'When [the English statute] speaks of a bad debt it means a debt which is a debt that would have come into the balance sheet as a trading debt in the trade that is in question and that it is bad. It does not really mean any bad debt which, when it was a good debt, would not have come in to swell the profits.'*

9. In the present case, had the debt not been bad, it would not have come in to swell the profits of the Taxpayer. Thus, the debt was not a debt incurred in the trade of the Taxpayer within the meaning of section 16(1)(d) of the Ordinance.

WHETHER OUTGOING OR EXPENSE UNDER SECTION 16(1)

10. It is the contention of the Revenue that there was no 'residuary' deduction in the introductory words of section 16(1). In his careful submission to us, Mr Ng on behalf of the Revenue relied on two cases in support of this contention. The first is the case of CIR v County Shipping Company Limited [1990] 3 HKTC 267, CA. However, that was a case where the facts clearly fell into section 16(1)(a) which provided that subsection (2) should apply. In those circumstances, it is not surprising that the Court of Appeal held that section 16(1)(a) and (2) must apply and there was no room for the introductory words of section 16(1) to apply to the exclusion of paragraph (a) of subsection (1) and subsection (2) of section 16.

11. The next case was a decision of this board in Case No D67/91, IRBRD, vol 7, 227. That was also a case where the facts fell clearly within section 16(1)(d). In other words, it was, again, not a case where the facts did not fall within any of the subparagraphs of section 16(1).

12. Mr Chan on behalf of the Taxpayer, on the other hand, advocated that the present loss should be covered by the introductory words of section 16(1). He could not, however, produce any authorities to support this contention.

13. In our view, whether the loss in question is a deduction under section 16(1) depends on two things: first, whether the loss can really be said to be an outgoing or an

expense; secondly, whether the loss was an outgoing or expense within in meaning of the Ordinance.

WHETHER LOSS AN OUTGOING OR EXPENSE

14. The loss in question was not an ordinary day occurrence. It was not even a normal disbursement or expenditure incurred in the course of trade. There is a clear distinction between a loss and an expense. This distinction was commented on by Finlay J in Allen v Farquharson Brothers & Co [1932] 17 TC 59 at page 64:

> *'I do think that there is a distinction to be drawn between the two. … [disbursement] means something or other which the trader pays out; I think some sort of volition is indicated. He chooses to pay out some disbursement; it is an expense; it is something which comes out of his pocket. A loss is something different. That is not a thing which he expends or disburses. That is a thing which, so to speak, comes upon him ab extra. It is not very easy to formulate the thing, but it is easy enough to put illustrations falling on one side or the other of the line which may show what is, I think, the distinction, and the real distinction, between these things. Take the case of money being stolen from the till: I should say that that, quite plainly, was not a disbursement or an expense and, equally plainly, I should say it was a loss.'*

15. The word 'outgoings' bears a similar meaning to the word 'expenses'. It means a regular outlay, payment or expense (see The Shorter Oxford Dictionary, third edition, volume II, at page 1474). In Yates v Yates [1913] 33 NZLR 281, Cooper J said (at page 285):

> *'"Outgoings" is a proper word to use in connection with rent, salaries, and expenses or management.'*

16. Section 16(1) does not permit deduction of a loss but only outgoings and expenses. Indeed, the Ordinance itself draws a distinction between a loss and an expense: see section 17(I)(c). In our view, the debt written off here is a loss and not an outgoing or expense. It follows that the appeal must fail on this ground alone.

WHETHER LOSS INCURRED 'IN THE PRODUCTION OF PROFITS'

17. But even assuming the loss here was an outgoing or an expense, the Taxpayer must still show that the loss was incurred 'in the production of profits'. It is here that we must examine the legislative scheme of the Ordinance.

18. On this point we can do no better than to cite the words of Lord Brightman in Lo & Lo v CIR [1984] 2 HKTC 34, PC, at page 71:

> *'Under the Hong Kong system of taxation, the legislative scheme is to provide exhaustively for the items which may be deducted from receipts when*

ascertaining the taxable profit, regardless of good accountancy practice. In this respect the Hong Kong legislation was similar to that of Australia and New Zealand, where comparable sums had been held not to be deductible. The taxpayer referred in particular to ***CIR v Mutual Investment Company Limited*** *[1967] 1 AC 587, where* ***Sir Garfield Barwick,*** *delivering the opinion of the Board, said (page 598):*

> *'It is clear enough that sections 16 and 17 provide exhaustively for the deduction side of the account which is to yield the assessable profits.'*

this observation was made in the context of an earlier, but not significantly different, version of the ***Inland Revenue Ordinance.***

It is perfectly correct to say that sections 16 and 17 provide exhaustively for the deductions which are permissible to be made, but not in the sense that permitted deductions are confined to the particular matters specified in paragraphs (a) to (h) of section 16(1). Sections 16 and 17 provide exhaustively for the deductions in the sense that permitted deductions are confined to outgoings and expenses ***incurred in the production of profits*** *in respect of which tax is chargeable; that such permitted deductions expressly include those specified in (a) to (h) of section 16(1), and expressly exclude those in section 17.' (emphasis added)*

19. In the more recent case of Wharf Properties Limited v CIR [1994] 1 HKRC 90-073, Chan J said (at page 100,668):

> *'In my view, sections 16 and 17 are separate provisions and perform different functions. One offers inclusion for certain types of outgoings and expenses in the process of ascertaining assessable profits while the other provides exclusion of certain types of outgoings and expenses in the same process. In almost all of the cases, it is of course true that outgoings and expenses which do not fall within section 16 are outside section 17 and those which are excluded under section 17 would not normally qualify under the inclusive provision of section 16. However, the two issues are to be dealt with separately. The correct approach is that one should consider first of all whether an item of expenditure falls to be included under section 16 and then whether it is excluded under section 17. If the item does not fall within section 16, that is the end of the matter. It will not be allowed as a deduction. But even if it falls within section 16, it has still to be considered whether it is excluded under section 17. If it is excluded, it will not be allowable as a deduction. It is only when a particular item qualifies under* ***both*** *sections 16 and 17 that it is permissible as a deduction for the purpose of ascertaining the assessable profit.'*

20. In the present case, the crucial words in the introductory words of section 16(1) are:

> *'… There shall be deducted all outgoings and expenses to the extent to which **they are incurred … in the production of profits** in respect of which he is chargeable to tax …' (emphasis added)*

21. These words, in our view, must be considered in the light of section 17(1)(b):

> *'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*
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> …
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> *(b) any disbursements or expenses not being money expended **for the purpose of producing such profits;'** (emphasis added)*

22. It is settled law that despite the difference in wording, the expression 'in the production of profits' and the expression 'for the purpose of producing … profits' mean exactly the same thing:

> *'As I said, in order to satisfy section 16(1)(a), it is necessary to show that both the loan as well as the interest thereon must be obtained or incurred in the production of assessable profits. "In the production of assessable profits" and "for the purpose of producing assessable profits" have and should have the same meaning. It means "with a view to" producing profits for the business (see **Yang J,** as he then was, in CIR v Swire Pacific Limited [1979] HKTC 1145 at page 1160 and also the decision of the Court of Appeal from page 1162), or "in the course" of producing assessable profit and "incidental and relevant" to the business (see Ronpibon Tin N L v Federal Commissioner of Taxation [1949] 8 ATD 431 at page 435).'*
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> *Per Chan J in Wharf Properties Limited v CIR [1994] 1 HKRC 90-073 at page 100,669.*

23. What expenses then are expenses incurred in the course of producing assessable profits? In Strong & Co of Romsey Ltd v Woodifield [1906] AC 448, [1906] 5 TC 215, HL Lord Loreburn L C said (at page 219):

> *'In my opinion, however, it does not follow that if a loss is in any sense connected with the trade, it must always be allowed as a deduction; for it may be only remotely connected with the trade or it may be connected with something else quite as much as or even more than with the trade. I think only such losses can be deducted as are connected with it in the sense that they are really incidental to the trade itself. They cannot be deducted if they are mainly incidental to some other vocation, or fall on the trade in some character other than that of the trader. The nature of the trade is to be considered.'*

24. Lord Davey in the same case said this (at page 220):

> *'I prefer to decide the case upon Rule I [of Income Tax Act 1842, section 100, Sch D, Cases I and II], which applies to profits of trades and also to professions, employments, or vocations. I think that the payment of these damages was not money expended "for the purpose of the trade". These words … appear to me to mean for the purpose of enabling a person to carry on and earn profits in the trade, etc. I think the disbursements permitted are such as are made for that purpose. It is* ***not*** *enough that the disbursement is made in the course of, or arises out of, or is connected with, the trade or is made out of the profits of the trade. It must be made* ***for the purpose of earning the profits.' (emphasis added)***

25. In Curtis v J & G Oldfield Limited [1925] 9 TC 319, a managing director took some £14,000 from the company. Upon his death, the debt was written off as bad. The Court held that the loss was not a trading loss. At page 330, Rowlatt J said:

> *'… I have to consider whether there is the least ground for supposing that losses of these sums resulting in this bad debt were losses in the trade. I quite think, … that if you have a business… in the course of which you have to employ subordinates, and owing to the negligence or the dishonesty of the subordinates some of the receipts of the business do not find their way into the till, or some of the bills are not collected at all, or something of that sort, that may be an expense connected with and arising out of the trade in the most complete sense of the word. But here that is not the case at all. … I do not see that there is any evidence at all that there was a loss in the trade in that respect. It simply means that the assets of the Company, money which the Company had got and which had got home to the Company, got into the control of the Managing Director of the Company, and he took them out. It seems to me that what has happened is that he has made away with receipts of the Company* ***dehors*** *the trade altogether in virtue of his position…'*

26. Similarly in Bamford v ATA Advertising Ltd [1972] 48 TC 359, Brightman J said (at page 368A):

> *'Mr Beattie submitted that there is no logical distinction to e drawn between petty theft by a subordinate employee and massive defalcation by a director. In my view there is a distinction. I can quite see that the Commissioners might find as a fact that a £5 note taken from the till by a shop assistant is a loss to the trader which is connected with and arises out of the trade. A large shop has to use tills and to employ assistants with access to those tills. It could not trade in any other way. That, it seems to me, is quite a different case from a director with authority to sign cheques who helps himself to £15,000, which is then lost to the company. I find it difficult to see how such a loss could be regarded fairly as "connected with or arising out of the trade". The loss is not, as in the case of dishonest shop assistant, an incident of the company's trading*

> *activities. It arises altogether outside such activities. That, I think is the true distinction.'*

27. The analysis above relating to directors is equally apposite to a deposit of money with a bank. Assuming for the benefit of the Taxpayer the loss in question does amount to an outgoing or expense, the key question is: was this expense incurred **in the production of profits** in respect of which tax is charged or **for the purpose of producing such profits?**

28. We think not. There is nothing to suggest that depositing the money with the Bank was a necessary step in carrying on the Taxpayer's trade or that it formed part of the business of the Taxpayer. Test it this way: would the Taxpayer be able to carry on its trade in the normal way if the money was not deposited with the Bank? The obvious answer is: of course it would. The money can be kept in a safe, or kept by its directors, or its accountant, or even lent to a third part. It might not be very convenient to the Taxpayer but that is not the relevant criterion.

29. Our view is further fortified by the case of Hagart and Burn-Murdoch v CIR [1929] AC 386, HL. There, the Taxpayer advanced money from time to time to a customer. The customer's business failed and the loan became irrecoverable. It was held that the loss was not a permissible deduction, as it did not represent moneys wholly and exclusively laid out or expended for the purpose of the Taxpayer's trade. At page 391, Lord Buckmaster said:

> *'In my opinion the loss of money so advanced cannot be treated as a loss in ascertaining the profits and gains of [the Taxpayer]; …*
>
> *I agree with the criticism of the Dean of Faculty that in the present case to consider whether the source from which the moneys came was capital or income is not to apply the true test. In this instance it is the application of the moneys and not their origin that provides the real criterion.' (see also, W A & F Rutherford v CIR [1939] 23 TC 8; and Bury & Walkers v Phillips [1951] 32 TC 198.)*

OUR DECISION

30. For these reasons, we think that the Taxpayer's argument that the loss resulted from a loss of the revenue of the Taxpayer and thus was a deductible expenditure is misconceived and the appeal must fail.