Case No. D58/01

Profits tax – whether the sums payable by way of interest chargeable to tax – onus on the taxpayer to establish the identity of the lender – the twin conditions for deductibility imposed by section 16(2) of the Inland Revenue Ordinance (' IRO') – sections 14(1), 15(1), 16(1) and 16(2) of the IRO.

Panel: Ronny Wong Fook Hum SC (chairman), Peter Sit Kien Ping and Anthony So Chun Kung.

Date of hearing: 31 March 2001.
Date of decision: 25 July 2001.

This was an appeal by the taxpayer, a private company incorporated in Hong Kong, which was involved in the business of property acquisition. The main issue was whether the sums paid by the taxpayer to another company (Company D), which was a joint venture company incorporated in the PRC and carried on business overseas, by way of interest were chargeable to profits tax under the IRO, if so, whether section 16(2) of the IRO could be invoked for deductibility in ascertaining the profits concerned. In deciding on this main issue, it involved two questions:

1. the existence or otherwise of the loans; and

2. who the lender was and whether such lender was a person other than a financial institution or an overseas financial institution.

Held:

1. With supporting evidence, the Board accepted that the taxpayer did not have internal resources to finance its property acquisitions in Hong Kong and such acquisitions were supported by loans extended in favour of the taxpayer.

2. The onus was on the taxpayer to establish that Company D was the lender of the loans rendered to it. The Board had serious reservations on whether the taxpayer had properly discharged its onus in relation to this condition.

3. In deciding the sums payable by way of interest chargeable to tax under the IRO, it turned on the question whether Company D carried on a business in Hong Kong for the purpose of section 14 of the IRO and whether the sums in question were received by or accrued to Company D by way of interest arising through or from the

carrying on by Company D of its business in Hong Kong for the purpose of section 15(1)(f) of the IRO: CIR v Bartica Investment Ltd (1996), IRBRD, vol 11, 371.

4. The Board had no doubt that Company D did not carry on business in Hong Kong. It was a joint venture company incorporated in the PRC and carried on business overseas. It did not keep any of its accounting and other records in Hong Kong. All the negotiations and decisions pertaining to the loans were conducted in the PRC. Whilst this factor alone was not decisive, it was a relevant consideration and weakened the weight to be attached to the execution of the loan agreement in Hong Kong. The interest in question was not paid in Hong Kong but was effected by the transfer of entries in the PRC.

Appeal dismissed.

Cases referred to:

CIR v Bartica Investment Ltd (1996), IRBRD, vol 11, 371
De Beers Consolidated Mines Ltd v Howe [1906] AC 455

Chan Tak Hong for the Commissioner of Inland Revenue.
Dennis Law Shiu Ming Counsel instructed by Messrs Tony Kan & Co for the taxpayer.

Decision:

Background

1. The Taxpayer is a private company incorporated in Hong Kong on 4 July 1995. Mr A, Ms B and Ms C were appointed directors of the Taxpayer on 18 July 1995.

2. By a guarantee dated 13 September 1995, Mr A undertook to shoulder all loss arising from the Taxpayer' s failure to repay loans taken out by Company D from Bank E, City F Branch in China and Co-operative Society G for the purpose of on-lending to the Taxpayer. Company D is a company registered in China on 9 November 1989.

3. By letter dated 21 September 1995, the Taxpayer informed Company D that they had completed the drafting of a loan agreement as discussed between the parties. The Taxpayer invited Company D to send a representative to Hong Kong to execute that agreement. Company D replied on 25 September 1995 indicating that the despatch of their general manager Mr H to Hong Kong on 1 October 1995 for that purpose.

4. By a loan agreement dated 1 October 1995 (' the Loan Agreement'), Company D agreed to advance funds to the Taxpayer as its circulating capital with interest at 3% per annum. Interest is to be computed at the end of each month. The principal and interest are to be repaid in Hong Kong either in cash or in such other form as may be agreed between the parties.

5. According to a statement of account between the Taxpayer and Company D for the period between 4 July 1995 and 31 December 1996 (' Account I'):

(a) Company D made substantial advances in favour of the Taxpayer the first of which was an advance of $20,000,000 on 19 October 1995. These advances were allegedly evidenced by fixed deposit receipts issued by Bank I in favour of the Taxpayer or by pay-in slips in respect of payments into the Taxpayer' s account with the same bank.

(b) Interest in respect of the amounts lent was credited in favour of Company D.

(c) There were occasions when the Taxpayer defrayed various sums on behalf of Company D. These items were debited against Company D.

(d) The total indebtedness of the Taxpayer towards Company D as at 31 December 1996 was $671,806,016.34.

6. The Taxpayer utilised the amounts so advanced in purchasing various landed properties in Hong Kong and City F. For the period ended 31 December 1996, the Taxpayer purchased a total of 28 properties in the sum of $805,000,000. For the period between 1 January 1997 and 31 March 1998, the Taxpayer purchased a further 49 properties in the sum of $1,743,000,000.

7. The Taxpayer produced various receipts in respect of interest paid to Company D. The first of such receipt is dated 18 September 1996 whereby Company D acknowledged payment of ¥10,900 as interest for the period between October and December 1995. This sum was paid by transfer of entries (對數). Other receipts reflect payment of interest by like means.

8. According to a statement of account between the Taxpayer and Company D for the period between 1 January 1997 and 31 March 1998 (' Account II'):

(a) Various sums were advanced by Company D to the Taxpayer through a Hong Kong company, Company J.

(b) The Taxpayer expended sums on behalf of Company D in Hong Kong for the acquisition of shares of Hong Kong listed companies. The Taxpayer also paid various Hong Kong suppliers on behalf of Company D for goods sold by those suppliers to Company D.

(c) The Taxpayer allegedly made payments to Company D in respect of interest and repayment of principal. These payments were said to have been evidenced by correspondence exchanged between the parties.

(d) After setting off their respective liabilities, there was no further outstanding between the Taxpayer and Company D as at 31 March 1998.

9. In its financial statements for the period from the date of incorporation (4 July 1995) to 31 December 1996, the Taxpayer described its principal activities as 'rental income from investment properties'. In its tax computation, the Taxpayer computed assessable profits of $14,587,349 for the period. This figure was arrived at after deducting loan interest of $23,986,901. Out of the loan interest of $23,986,901, $20,615,510 was incurred on loans extended by Company D. The issue before us relates to the Taxpayer's entitlement to deduct this sum apportioned as to $6,808,792 for the year of assessment 1995/96 and $13,806,718 for the year of assessment 1996/97.

The relevant provisions in the IRO

10. Section 14 of the IRO provides that profits tax shall be charged on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business.

11. Section 15(1) of the IRO provides:

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For th

(a) ...

(f) *sums received by or accrued to a corporation carrying on a trade, profession or business in Hong Kong by way of interest derived from Hong Kong.*'

12. Section 16(1)(a) of the IRO provides:

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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) is satisfied, sums payable by such person by way of interest upon any money borrowed by him for the purpose of producing such profits, and sum payable by such person by way of legal fees, procuration fees, stamp duties and other expenses in connection with such borrowing.*'

13. Section 16(2) of the IRO provides:

‘ *The co*

(a) ...

(b) ...

(c) *the money has been borrowed from a person other than a financial institution or an overseas financial institution and the sums payable by way of interest are chargeable to tax under this Ordinance;*

(d) ...

(e) *the money has been borrowed wholly and exclusively to finance –*

(i) *capital expenditure incurred on the provision of machinery or plant which qualifies for an allowance under Part VI; or*

(ii) ...

and –

(A) *the lender is not an associate of the borrower; and*

(B) *where the money is borrowed from, or the relevant sum payable by way of interest upon the money is payable to, a trustee of a trust estate or a corporation controlled by such a trustee, each of the trustee, the corporation and the beneficiary under the trust is not an associate of the borrower.*’

Case of the Taxpayer

14. In correspondence with the Revenue, the Taxpayer once placed reliance on section 16(2)(e)(i) of the IRO. Mr Law, Counsel for the Taxpayer, does not seek to justify such reliance in the hearing before us.

15. The Taxpayer maintains that loans were extended by Company D as principal in the Taxpayer’ s favour. The loans were not extended by Bank E nor Co-operative Society G.

16. The twin conditions for deductibility imposed by section 16(2) of the IRO are satisfied. Company D is not a financial institution nor an overseas financial institution. Company D carried on

business in Hong Kong and the sums paid by the Taxpayer to Company D by way of interest are chargeable to profits tax under the IRO. Reliance is placed on section 15(1)(f) of the IRO.

Case of the Respondent

17. The Revenue contends that there is no evidence to suggest that Company D was acting as agent of Bank E and Co-operative Society G in extending loans in favour of the Taxpayer. This contention of the Revenue stems from a misunderstanding of the Taxpayer' s case. It would not advance the Taxpayer' s position if the loans were extended by Bank E and Co-operative Society G as the first condition for deductibility under section 16(2) would not be met. Such a contention did not form part of the Taxpayer' s case.

18. The Revenue argues that the Taxpayer has not discharged the onus in demonstrating that loans were indeed advanced by Company D in favour of the Taxpayer.

19. The Revenue hotly disputes that the sums payable by way of interest to Company D are chargeable to profits tax under the IRO. Company D did not carry on any business in Hong Kong. Company D is not chargeable to profits tax under sections 14(1) and 15(1)(f) of the IRO.

Evidence of the Taxpayer

20. Mr A gave sworn testimony before us. In his evidence in chief, he adopted his written statement dated 16 March 2001 wherein he stated that:

(a) Company D ' was a joint venture company incorporated in the PRC and carried on business at Address K in City F.' His good friend Mr H was the managing director of Company D and he himself was its deputy general manager.

(b) The Taxpayer was incorporated on 4 July 1995. It had no assets on incorporation. It was therefore difficult for the Taxpayer to obtain finance from the local financial institutions.

(c) In about August/September 1995, he went to Bank E and Co-operative Society G to discuss about banking facilities matters. ' I was given to understand that both the Bank and the Society were willing to give financial support but because of the relevant PRC banking regulations, they could only grant loans to companies incorporated in the PRC. It was then agreed that the loans from the Bank and the Society would be given first to [Company D] ***acting on our behalf***. The arrangement was that [Company D] would remit the loans so obtained to [the Taxpayer] through a loan agreement and interest would be paid by [the Taxpayer].' (emphasis supplied).

(d) ' Pursuant to the aforesaid arrangement, on 13 September 1995, I duly executed a personal guarantee ... in favour of [Company D] in respect of the loans from the Bank and the Society to [Company D]. Thereafter from time to time loans were granted by the Bank and the Society to [the Taxpayer] through [Company D] ...' .

21. Mr A further told us that:

(a) He went up to China and negotiated with Bank E and Co-operative Society G for the extension of a ¥800,000,000 loan. It was intended that the principal be repaid within one year with liberty to extend the duration of the loan.

(b) He and Mr H came from the same village in China. He was asked to assist in procuring a loan in China as the Taxpayer was only an entity registered in Hong Kong. The 3% rate of interest was within the limits permitted in China. In cross-examination, he admitted that no profit should have accrued to Company D arising from these loans. In re-examination, he said that Company D might have advantage arising from payment in Hong Kong dollars but he cannot say whether there was in fact any profit or loss.

(c) It was decided that the loan agreement between the Taxpayer and Company D be signed in Hong Kong. Company D had other business in Hong Kong. It purchased cars and machine parts in Hong Kong. At the direction of Company D, the Taxpayer also entertained in Hong Kong various visitors from China.

(d) The ¥800,000,000 loan was remitted in stages to Hong Kong. Four to five accounts were used. Company J was one of them.

(e) There were repayments of principal in favour of Bank E and Co-operative Society G when they pressed for the same.

(f) At times, Company D paid Bank E and Co-operative Society G interest on the outstanding loans. The amount so paid would be adjusted ' internally' between Company D and the Taxpayer.

The first condition - has money been borrowed from a person other than a financial institution or an overseas financial institution?

22. This involves two questions:

(a) the existence or otherwise of the loans and

(b) who the lender is and whether such lender is a person other than a financial institution or an overseas financial institution.

23. We accept the evidence of Mr A that the Taxpayer did not have internal resources to finance its property acquisitions in Hong Kong and such acquisitions were supported by loans extended in favour of the Taxpayer. The deposit receipts and the customer' s advice issued by the Bank I reinforce the subsistence of such loans.

24. The Taxpayer says that Company D is the lender. The onus is on the Taxpayer to establish this relationship to our satisfaction. The Taxpayer relies on the guarantee dated 13 September 1995, the loan agreement dated 1 October 1995 and the entries in Accounts I and II. We have also borne in mind the Revenue' s position as referred to in paragraph 17 above.

25. There are pointers indicating otherwise:

(a) The Taxpayer has not produced any document emanating from Bank E or Co-operative Society G. Such document would throw important light on the true relationship between the parties.

(b) Paragraph 4 of the written statement of Mr A indicates that he made the initial approach on behalf of the Taxpayer. Bank E and Co-operative Society G were willing to give financial support. In order to comply with PRC banking regulations, the loans would first be given to Company D ' acting on [the Taxpayer' s] behalf. The arrangement was that [Company D] would remit the loans so obtained to [the Taxpayer] through a loan agreement and interest would be paid by [the Taxpayer]' . This piece of evidence from Mr A is most ambiguous. It suggests that Bank E, Co-operative Society G, Company D and the Taxpayer were parties to an arrangement whereby all participants intended Company D to act as agent of the Taxpayer attracting no personal liability with the Taxpayer assuming ultimate responsibility towards Bank E and Co-operative Society G in relation to the loans so granted. The guarantee dated 13 September 1995 is equally consistent with an intention to indemnify Company D for any exposure arising from their agency.

(c) The Taxpayer has not produced any document to indicate how the loans extended by Bank E and Co-operative Society G were drawn down and serviced. If the true intention between the parties was the acceptance of personal liability by Company D, one would expect notices of drawdown by Company D and demands for repayment addressed to Company D.

(d) The deposit receipts and the customer' s advices from Bank I to the Taxpayer give no clue as to the source of fund. They do not establish Company D as the lender.

26. We have serious reservations on the question whether the Taxpayer has properly discharged its onus in relation to this condition. We do not, however, wish to decide this appeal on this ground bearing in mind the stance of the Revenue referred to in paragraph 17 above and our clear conclusion in relation to the second condition.

The second condition - are the sums payable by way of interest chargeable to tax under the IRO?

27. This turns on the question whether Company D carried on a business in Hong Kong for the purpose of section 14 of the IRO and whether the sums in question were received by or accrued to Company D by way of interest arising through or from the carrying on by Company D of its business in Hong Kong for the purpose of section 15(1)(f) of the IRO.

28. Both sides referred to CIR v Bartica Investment Ltd (1996), IRBRD, vol 11, 371 for the applicable principles. There is little dispute between the parties that this case supports the following propositions:

(a) In the case of company incorporated for the purpose of making profits for its shareholders any gainful use which puts any of its assets prima facie amounts to the carrying on a business.

(b) While ultimately it is a question of fact whether a taxpayer was carrying on business, the prima facie inference for a company incorporated for the purpose of making profits for its shareholders and puts its assets to gainful use is that it is carrying on a business.

(c) Whether a business is carried out in a place is a question of fact. In considering whether the business was carried on in Hong Kong, the principle in De Beers Consolidated Mines Ltd v Howe (1906) AC 455 could not be the guiding principle as the issue in that case was whether a foreign corporation was considered to be a resident in UK for the purpose of tax.

29. We have no doubt that Company D did not carry on business in Hong Kong. It is a joint venture company incorporated in the PRC and carried on business at Address K in City F. It did not keep any of its accounting and other records in Hong Kong. All the negotiations and decisions pertaining to the loans were conducted in the PRC. Whilst this factor alone is not decisive, it is a relevant consideration and weakens the weight to be attached to the execution of the 25 September 1995 loan agreement in Hong Kong. The interest in question was not paid in Hong Kong but was effected by the transfer of entries in the PRC.

30. For these reasons, we dismiss the Taxpayer' s appeal and confirm the assessments.