INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D58/02

Profits tax – whether certain sums are deductible as outgoings and expenses under section 16(1) – mere compliance with section 16(1) is not sufficient, it must also not be excluded under section 17(1) – sections 14, 16, 17 and 68(4) of the Inland Revenue Ordinance ('IRO').

Panel: Anna Chow Suk Han (chairman), Kenneth Graeme Morrison and Alexander Woo Chung Ho.

Date of hearing: 13 August 2002.
Date of decision: 10 September 2002.

The taxpayer, a public company listed on the Stock Exchange of Hong Kong since November 1990, appealed against a determination of profits tax assessments for the years of assessment 1998/99 and 1999/2000.

In the former year of assessment, it claimed that a rental deposit ('the Deposit') written off should be allowed as a deduction when computing its assessable profits. In the latter year of assessment, it claimed that a sum ('the Sum') which was set off against the rent withheld should be allowed as a deduction for the purpose of computing its assessable profits.

The issues in this appeal were:

(a) whether the two items of claim, that is, the Deposit written off and the Sum set off, were expenses or outgoings as to qualify as deductions under section 16(1); and

(b) if they were expenses or outgoings, whether they would be excluded for deduction under section 17.

Held:

1. Section 14 of the IRO is the charging provision for profits tax.

2. Sections 16 and 17 provide for the deductions to be permitted or excluded for profits tax purposes.

3. Section 68(4) puts the burden of proof that the assessment appealed against is excessive or incorrect on the appellant.

4. Whether an item is an allowable deduction is governed by sections 16 and 17 of the IRO.

5. Section 16(1) contains 'the general rule' relating to the permissibility of making deductions for the purpose of ascertaining assessable profits. The effect of this subsection is that it permits deductions of all outgoings and expenses which satisfy two criteria, (1) they must be incurred in the production of assessable profits and (2) they must be incurred during the basis period for the year of assessment in question.

6. On the other hand, section 17 sets out the various types of outgoings and expenses which are not permissible as deductions.

7. It followed that if the expenses or outgoings did not qualify as deductions under section 16(1), the Board needed not go further to consider whether they would be excluded under section 17 because they were not allowable deductions. However, even if they fell within section 16(1), the Board still needed to consider whether they would be excluded under section 17. Only when they qualified under both sections 16(1) and 17, they were allowable deductions.

8. The Board disagreed with the Commissioner's contention that the Deposit written off was not a loss of capital but was an expense of the taxpayer.

9. The Board did not accept the contention that in ordinary language people would regard the payment of a rental deposit as an outgoing or expense of running a business.

10. In the case of a lease between a lessor and a lessee, the purpose of the payment of a deposit by the lessee is to secure the due performance of the obligations, including but not limited to, payment of rent on the part of the lessee under the lease. Upon fulfillment of those obligations, the lessee is entitled and also expects the deposit to be repaid. The deposit is placed with the lessor for the duration of the lease, who has no right to it unless there is non-fulfillment of the obligations on the part of the lessee.

11. Unless the lease stipulates otherwise, even when there is non-fulfillment of the lessee's obligations, the lessor will only be entitled to such part of the deposit which represents the damages suffered by the lessor or the lessor will be entitled to more if the damages suffered exceed the deposit paid under the lease.

12. Thus, in ordinary language people do not treat the payment of deposit as an outgoing or expense which is spent. The deposit is placed with the lessor pending fulfillment of the obligations on the part of the lessee and is money belonging to the lessee.

13. For accounting purpose, the deposit held by the lessor in the interim will be classified as an asset and not an expenditure of the lessee in the lessee's account.

14. Thus, if the deposit is not returned to the lessee by reason of the lessor's default, it will be a loss of an asset to the lessee and not an expense incurred.

15. In the view of the Board, the non-refund of the deposit by a lessor was similar in nature as a theft of money in a till or a loss of a deposit at bank which went bankrupt.

16. The view of the Board was also supported by the documentary evidence produced by the Revenue. It was evident even from the taxpayer's own accounts that the taxpayer did not treat the Deposit as an expense or outgoing incurred by it but the Deposit was an amount due to it from a third party. As such, the payment of the Deposit was not an expense incurred and the write-off of it did not qualify as a deduction under section 16(1).

17. As to the Sum, prior to the hearing of the appeal, the Board had little or no information on how the Sum was incurred by the taxpayer. During the hearing, evidence was given for the taxpayer in this regard. It was said that for practical reasons, the taxpayer first settled these amounts and then sought reimbursements from Company F, a wholly owned subsidiary of the holding company of the taxpayer.

18. The evidence before the Board showed that the taxpayer was not obliged to make payment of the relevant three items which made up the Sum. Those relevant three items fell within the responsibility of Company F. If the payment was made by the taxpayer, it would be a loan from the taxpayer to Company F and was not an expense or outgoing of the taxpayer incurred in production of its chargeable profits and thus did not qualify as a deduction under section 16(1). No documentary evidence was produced to prove that such payments were indeed made by the taxpayer. It was an assertion on the part of the taxpayer. It had not been proved as a fact.

19. Even if there were payments made (which was not accepted by the Board), those payments were loans to Company F and were not expenses incurred in production of the taxpayer's chargeable profits and did not qualify as deduction under section 16(1).

20. Even if the Board was wrong in reaching the aforesaid conclusion that the Deposit and the Sum, if paid, were not expenses or outgoings to qualify as deductions under section 16(1) of the IRO and instead if they were the taxpayer's expenses or outgoings, the Board found that they were expenses or outgoings of a capital and not of a revenue nature and thus were excluded for deduction under section 17(1)(c).

21. Section 17(1)(c) provides that no deduction shall be allowed in respect of 'any expenditure of a capital nature' or 'any loss or withdrawal of capital'.

22. In the view of Chan J in Wharf Properties Limited v CIR 4 HKTC 310 at page 347, section 17(1) covers 'expenditure which is itself incurred as a capital and expenditure which, although not a capital in itself, is payment of a capital nature'.

23. If the expenditure was a capital payment, it was of course caught by section 17(1). But even if it was not a capital payment, the Court had to consider whether it was of a capital nature or revenue nature.

24. Further, according to Chan J, in order to decide the question of whether an expenditure was of a capital or revenue nature, one had to examine not only the status or nature of the expenditure but also the reason or purpose for which and the circumstances under which it was incurred. None of the tests was decisive. The answer to the question depended very much on the facts of each case and ultimately it was 'common sense appreciation of all the guiding features' which would provide the answers.

25. The Board had been referred to the Wharf case for the various tests laid down in some previous decisions on the question of 'whether a particular payment or item of expenditure can be regarded as capital in nature'. The more important and common tests applied in the Wharf case were: (a) fixed or circulating capital test, (b) once and for all or securing expenditure test, (c) enduring benefit test, (d) profit yielding structure test and (e) the three matters considered by Dixon J in Sun Newspapers Limited & Associated Newspaper Limited v Federal Commissioner of Tax [1938] 5 ATD 87, that is, (1) the character of the advantage sought, (2) the manner in which it is to be used, relied upon or enjoyed and (3) the means adopted to obtain it.

26. The Board agreed with the taxpayer's contention that a 'once and for all' payment could also be an expenditure attributable to revenue and not to capital. However, the Board failed to find that the expenditure in the present case was of a revenue nature.

27. In the Board's view, to say that the payment of a rental deposit to secure the due payment of rent was equal to a payment of rent was a fallacy.

28. Clause 4 of the Lease provided that the payment of the Deposit was made not only for the purpose of securing the due payment of rent but also for the due performance of the other terms and conditions under the Lease.

29. It was also provided under Clause 4 of the Lease that the Deposit would be returned to the taxpayer after the expiration of sooner determination of the Lease if there was no breach of the terms of the Lease by the taxpayer. Thus, it was clear from Clause 4 that the reason or purpose for the payment of the Deposit was to bring into existence the Lease. By applying just the fixed or circulating capital test, it was clear that the payment was of a capital nature.

30. The fixed or circulating capital test was propounded in the Wharf case, Ammonia Soda Company v Chamberlain [1918] 1 ChD 286 and BD Australia Limited v Federal Commissioner of Tax [1965] 112 CLR 386.

31. In the present case, to apply the fixed or circulating capital test and ask the question whether the expenditure was incurred in respect of fixed or circulating capital of the business, the answer to the question must be that it related to fixed capital and the expenditure was thus of a capital nature.

32. The Deposit was paid to secure the Lease which was retained by the taxpayer. The Lease enabled the taxpayer to use the Property where the taxpayer carried on its restaurant business. The Lease was not intended to return to the taxpayer with an increment. The Lease was intended to be used by the taxpayer to produce profits. Hence if the payment of the Deposit constituted an expenditure of the taxpayer, it would be attributable to capital and not revenue and so was the write-off of the Deposit.

33. Since the Board had found that there was no evidence of payment of the Sum by the taxpayer, the question of set-off of the Sum by the taxpayer against the rent withheld did not arise.

34. Even if the Sum was paid by the taxpayer (which the Board did not accept), the Board was of the view that the payment was a loan to Company F and not an expenditure of the taxpayer falling within section 16(1) of the IRO and thus did not qualify as a deduction.

35. Further, even if it constituted the taxpayer's expenditure, it was of a capital nature on the same basis of that of the Deposit and equally the set-off of the Sum against the rent withheld would be excluded for deduction under section 17(1)(c).

Appeal dismissed.

Cases referred to:

Allen v Farquharson Brothers & Co 17 TC 59
D55/95, IRBRD, vol 11, 10
Atherton v British Insulated and Helsby Cables Ltd 10 TC 155
Wharf Properties Limited v CIR 4 HKTC 310
Sun Newspapers Limited & Associated Newspaper Limited v Federal Commissioner of Tax [1938] 5 ATD 87
Ammonia Soda Company v Chamberlain [1918] 1 ChD 286
BD Australia Limited v Federal Commissioner of Tax [1965] 112 CLR 386

Tsui Siu Fong for the Commissioner of Inland Revenue.
Samuel Barns of PricewaterhouseCoopers Limited for the taxpayer.

Decision:

The appeal

1. This is the appeal by Company A ('the Taxpayer') against the determination of the Commissioner of Inland Revenue of 29 April 2002 on the profits tax assessments for the years of assessment 1998/99 and 1999/2000 raised on it.

2. For the year of assessment 1998/99, the Taxpayer claims that a rental deposit of $1,243,424 ('the Deposit') written off should be allowed as a deduction when computing its assessable profits.

3. For the year of assessment 1999/2000, the Taxpayer claims that a sum of $169,717 ('the Sum') which was set off against the rent withheld should be allowed as a deduction for the purpose of computing its assessable profits.

The relevant facts

4. The Taxpayer was incorporated as a private company in Hong Kong on 10 July 1990 and became a public company listed on the Stock Exchange of Hong Kong on 15 November 1990.

5. Before October 1993, the Taxpayer's holding company was Company B and after a group reorganization, Company B transferred its interest in the Taxpayer to a subsidiary Company C. In March 1997, Company D replaced Company C as the Taxpayer's ultimate holding company.

6. At all relevant times, the nature of business carried on by the Taxpayer was investment holding and the operation and management of restaurants.

7. Pursuant to a memorandum of understanding dated 6 March 1992 signed by the Taxpayer and Company B, the Taxpayer agreed in principal to lease from Company B part of the commercial complex at Housing Estate E for an initial term of four years renewable at the option of the Taxpayer for one further term of four years. On 24 July 1992, the Taxpayer signed a lease with Company F to lease the premises at the commercial development of Housing Estate E ('the Property'). Company F was the wholly owned subsidiary of Company B and later Company C.

8. The said lease was for a term of four years from 15 June 1992 to 14 June 1996 ('the Lease') with a right of renewal for a further term of four years. About the same time as entering into the Lease, the Taxpayer paid Company F a rental deposit of $1,110,200. The Lease was renewed by the Taxpayer for a further term of four years from 16 June 1996 to 15 June 2000. Upon renewal of the Lease, the Taxpayer paid Company F a further sum of $133,224 being the balance of the increased deposit on 12 July 1996. The Deposit in question represents the rental deposit of $1,110,200 and the further sum of $133,224.

9. By an assignment of rent of 3 August 1998, Company F assigned the rent under the Lease to Bank G in its capacity of security agent.

10. By a letter of 24 August 1998, Bank G through its solicitors demanded the Taxpayer to pay all future rent to Bank G direct.

11. Subsequently, the Property was offered for sale by a public tender. The Property was sold to Company H, Company I and Company J, subject to the renewed term under the Lease and to a condition that the receiver of the Property not having received the Deposit paid under the Lease, no deposit would be transferred to the purchaser.

12. The Property was subdivided into four shops, namely 'Shop 1', 'Shop 2', 'Shop 3' and 'Shop 4'. By an assignment of 23 April 1999, Company F assigned Shop 3 and Shop 4 to Company H. By a deed of surrender dated 23 July 1999, the Taxpayer surrendered Shop 3 and Shop 4 to Company H on 25 July 1999. The Lease for Shop 1 and Shop 2 was not surrendered but left to run until expiry.

13. On 4 November 1999, Company H assigned Shop 4 to Company K, a wholly owned subsidiary of the Taxpayer.

14. In its accounts for the year of assessment 1998/99, the Taxpayer claimed as a deduction the Deposit as 'write-off of rental deposit held by insolvent landlord'. The assessor did not accept that the Deposit written off was an allowable deduction.

15. PricewaterhouseCoopers Limited ('the Representative') on behalf of the Taxpayer objected to the assessment raised on the Taxpayer and claimed that the Deposit should be considered as an expense incurred in the production of chargeable profits and therefore deductible under section 16(1) of the IRO. In support of its objection, it contended that Company F up to 31 March 1999 had not refunded the Deposit to the Taxpayer and taking the view hat the recoverability of the Deposit was remote, the Taxpayer wrote off the amount in the year ended 31 March 1999.

16. The Taxpayer informed the assessor that the last rent payment made to Company F was for the month of August 1998; the rents from September 1998 to March 1999 were paid to Bank G; the rent for the month of April 1999 was withheld; and the subsequent rents from May 1999 onward were paid to Company H until the surrender of the Lease.

17. The Taxpayer also informed the assessor that since the Taxpayer did not hear from Bank G on the outstanding rent, the rent withheld was used to offset certain payments made by the Taxpayer to certain third parties on behalf of Company F and the balance of $451,995 was written back as income for the year of assessment 1999/2000 and the payments to those third parties were:

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Management fee deposit	80,652
Electricity deposit	73,786
Government rent (1-4-1999 to 23-4-1999)	15,279
	169,717

This sum of $169,717 is the Sum referred to in paragraph 3 above.

18. On 1 November 2000 the Taxpayer filed a proof of debt to the liquidator of Company C for the Deposit and the Sum less the rent withheld but the same was rejected by the liquidator on the ground that the Lease was entered into between the Taxpayer and Company F and was therefore not relevant to Company C. The Taxpayer took no other action to recover the Deposit as it was unable to establish any contact with Company F.

19. The assessor maintained the view that the Deposit written off was not an allowable deduction. On the same footing, the assessor did not accept that the Sum was deductible.

The Taxpayer's contentions

20. The Taxpayer's grounds of appeal are:

(a) The Deposit written off and the Sum set off against the rent withheld qualify for deduction under sections 14(1) and 16(1) of the IRO. In particular, they qualify as 'outgoings and expenses' and were incurred in the production of the Taxpayer's chargeable profits.

(b) The Deposit written off and the Sum set off are not expenditures of a capital nature so as to be prohibited from deduction by virtue of section 17(1)(c) of the IRO.

The Revenue's contentions

21. The reasons for the determination are:

(a) The Deposit was made to secure the due payment of rent under the Lease. It was neither a rent per se nor a rent paid in advance. Prior to the repayment, the Deposit was an asset to the Taxpayer and a liability to the landlord. The non-repayment of the Deposit was a loss, and not an outgoing or expense. Section 16(1) does not permit the deduction of a loss but only outgoings and expenses.

(b) Even if the Deposit could be regarded as an outgoing or expense, it was of a capital nature and was thus non-deductible. The underlying cause for paying the Deposit was to secure the Lease of the Property. The Deposit brought into existence a capital asset and a profit-yielding structure for the benefit of the Taxpayer's business.

(c) The Taxpayer wrote off the Deposit prior to the surrender of the Lease in relation to Shop 3 and Shop 4. It would appear that the Deposit was written off because of the acquisition of the Property through the Taxpayer's related companies and to facilitate the surrender. The write-off of the Deposit amounted to a release of liabilities which was of non-trading nature owed to the Taxpayer. As such, the Deposit written off could not be accepted as an expense incurred in the production of the Taxpayer's chargeable profits.

(d) On the same footing as the Deposit, the Sum which was paid to secure the Lease (a capital asset) is likewise not deductible.

The relevant statutory provisions

22. Section 14 of the IRO is the charging provision for profits tax. The section reads as follows:

> '*Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate 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 (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.*'

23. Sections 16 and 17 provide for the deductions to be permitted or excluded for profits tax purposes.

24. Section 16(1) reads as follows:

> '*In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment 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 under this Part 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, ...*
>
> *Provided that –*
>
> *(i) deductions 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 the business of the lending of money within Hong Kong, by a person who carries on that business;*
>
> ...'

25. Section 17(1)(b) and (c) reads as follows:

> '*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 –*
>
> ...
>
> *(b) ... any disbursements or expenses not being money expended for the purpose of producing such profits;*
>
> *(c) any expenditure of a capital nature or any loss or withdrawal of capital;*
>
> ...'

26. Section 68(4) puts the burden of proof on an appellant as follows:

> '*The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.*'

The decision

27. It is the Taxpayer's case that both items of claim, the Deposit written-off and the Sum set-off, were expenses incurred in the production of chargeable profits and were thus deductible under section 16(1) of the IRO. Further, they were not expenses of a capital nature. Hence, they did not disqualify for deduction under section 17(1)(c).

28. On the other hand, the Revenue contends that both items of claim were not expenses or outgoings to qualify as deductions under section 16(1) and even if they were expenses or outgoings, they were of capital nature and would disqualify for deduction under section 17(1)(c).

29. Whether an item is an allowable deduction is governed by sections 16 and 17 of the IRO. Section 16(1) contains 'the general rule' relating to the permissibility of making deductions for the purpose of ascertaining assessable profits. The effect of this subsection is that it permits deductions of all outgoings and expenses which satisfy two criteria, (1) they must be incurred in the production of assessable profits and (2) they must be incurred during the basis period for the year of assessment in question. On the other hand, section 17 sets out the various types of outgoings and expenses which are not permissible as deductions. It follows that if the expenses or outgoings do not qualify as deductions under section 16(1), we need not go further to consider whether they would be excluded under section 17 because they are not allowable deductions. However, even if they fall within section 16(1), we still need to consider whether they would be excluded under section 17. Only when they qualify under both sections 16(1) and 17, they are allowable deductions.

30. Thus, the issues for our determination are:

(a) whether the two items of claim, the Deposit written-off and the Sum set-off, are expenses or outgoings as to qualify as deductions under section 16(1); and

(b) if they are expenses or outgoings, whether they would be excluded for deduction under section 17.

31. In support of its contention, the Representative submitted on behalf of the Taxpayer as follows:

(a) Expenses or outgoings

(i) The making of a rental deposit came within the connotation of both 'outgoing' and 'expense' as defined in the Oxford English Dictionary.

(ii) The payment of the Deposit was a sum of money expended by the Taxpayer and it was an outgoing or an expense. Thus, when it was written off, it was correctly taken into account in calculating 'assessable profits' for the purposes of section 14(1) of the IRO. Section 17(1)(c) which prohibits deductions in respect of 'any expenditure of a capital nature or any loss or withdrawal of capital' was not applicable since there was no loss of capital in this case. The case of Allen v Farquharson Brothers & Co 17 TC 59 was referred to in which Finley J discussed disbursements or expenses in contrast to a loss.

(iii) The Commissioner referred to the Board of Review decision D55/95, IRBRD, vol 11, 10 where a sum deposited at a bank which was written off when the bank went bankrupt was held to be a loss and not an outgoing or expense. Notwithstanding this finding, the making of a rental deposit in connection with rented premises and its subsequent write-off must fall on the disbursements or outgoings or expenses side of the line. It was different from the loss of money held on deposit at a bank in the case of D55/95 which was similar in nature to Finley's J hypothetical case of money being stolen from a till. The critical distinction came down to this: in ordinary language people generally would not regard the putting of money on deposit at a bank as an outgoing or expense of running a business; however, in ordinary language people would regard the payment of a rental deposit as an outgoing or expense of running a business, in particular when something went wrong and the rental deposit was not repaid. In addition, in contrast with the deposit with a bank in the case of D55/95 which was found not to have incurred in the production

of profits, the payment of the Deposit in the present case was made in the production of profits.

(b) Capital expenditure or loss of capital

(i) It was suggested by the Commissioner in the determination that an outgoing or expense to be deductible had to be 'an ordinary day occurrence' or a 'regular outlay, payment or expense'. This suggestion was at odds with what Viscourt Cave said in Atherton v British Insulated and Helsby Cables Ltd 10 TC 155:

'... for it is easy to imagine many cases in which a payment, though made "once and for all" would be properly chargeable against the receipts for the year'.

(ii) The object and effect of the payment of the Deposit in the present case was, as provided under clause 4 of the Lease, to secure the due payment of the rents, as opposed to the reason given in the determination that the reason for payment of the Deposit was to secure the Lease of the Property. The payment of rent was clearly of a revenue nature. Thus, the non-return of the Deposit paid to secure the due payment of rent was similarly of a revenue nature.

(iii) From case law the general rule was that a premium paid for the grant of a lease was a capital expenditure on the part of the lessee and a capital receipt on the part of the lessor. The Commissioner was confusing the nature of a rental receipt with the nature of a premium for the acquisition of a lease.

(c) In the production of chargeable profits

The Commissioner suggested that the Deposit was written off because of the acquisition of the Property by the Taxpayer's related companies which rendered the write-off not incurred in the production of chargeable profits. This suggestion was incorrect because the Deposit was written off as a result of Company F's insolvency.

32. We have very carefully considered each and every argument advanced by the Representative for the Taxpayer. However, we are unable to come to terms with them.

The Deposit

33. Firstly, on the Representative's contention that the Deposit written off was not a loss of capital but was an expense of the Taxpayer, we disagree with the Representative that the write-off of the Deposit was an expense. We do not accept the contention that in ordinary language people would regard the payment of a rental deposit as an outgoing or expense of running a business. In the case of a lease between a lessor and a lessee, the purpose of the payment of a deposit by the lessee is to secure the due performance of the obligations, including but not limited to, payment of rent on the part of the lessee under the lease. Upon fulfillment of those obligations, the lessee is entitled and also expects the deposit to be repaid. The deposit is placed with the lessor for the duration of the lease, who has no right to it unless there is non-fulfillment of the obligations on the part of the lessee. Unless the lease stipulates otherwise, even when there is non-fulfillment of the lessee's obligations, the lessor will only be entitled to such part of the deposit which represents the damages suffered by the lessor or the lessor will be entitled to more if the damages suffered exceed the deposit paid under the lease. Thus, in ordinary language people do not treat the payment of deposit as an outgoing or expense which is spent. The deposit is placed with the lessor pending fulfillment of the obligations on the part of the lessee and is money belonging to the lessee. For accounting purpose, the deposit held by the lessor in the interim will be classified as an asset and not an expenditure of the lessee in the lessee's account. Thus, if the deposit is not returned to the lessee by reason of the lessor's default, it will be a loss of an asset to the lessee and not an expense incurred. In our view, the non-refund of the deposit by a lessor is similar in nature as a theft of money in a till or a loss of a deposit at bank which goes bankrupt.

34. Our view is also supported by the documentary evidence produced by the Revenue. We observe from the extracts from the Taxpayer's annual reports in its 'Notes to the Accounts regarding Current Assets' [R1 – pages 2, 4, 6, 8, 10 and 12], the 'Amounts due from fellow subsidiaries' which came under the Taxpayer's current assets were $1,264,638, $1,110,200, $1,110,200, $1,110,200, $1,243,424 and $1,243,424 respectively in the years ended 31 March 1993, 31 March 1994, 31 March 1995, 31 March 1996, 31 March 1997 and 31 March 1998. Although Miss L, the witness for the Taxpayer, was unable to confirm the components of the amount of $1,264,638 in the year ended 31 March 1993, it was pointed out to us by the representative of the Revenue during the hearing that the initial rental deposit ($1,110,200), the management fee deposit ($80,652) and the electricity deposit ($73,786) neatly came to this figure of $1,264,638. The Lease was renewed in March 1996 and the balance of the two month's rental deposit payable upon renewal of the Lease was $133,224 and was paid by the Taxpayer to Company F on 12 July 1996 [R1 – Appendix E]. The 'Amounts due from fellow subsidiaries' for the respective years ended 31 March 1997 and 31 March 1998 was $1,243,424 which must have represented the initial rental deposit ($1,110,200) and the further deposit ($133,224) paid on 12 July 1996. It is evident even from the Taxpayer's own accounts that the Taxpayer did not treat the Deposit as an expense or outgoing incurred by it but the Deposit was an amount due to it from a third party. As such, the payment of the Deposit was not an expense incurred and the write-off of it did not qualify as a deduction under section 16(1).

The Sum

35. Secondly, as to the Sum, prior to the hearing of the appeal, we had little or no information on how the Sum was incurred by the Taxpayer. During the hearing, Miss L gave evidence for the Taxpayer in this regard and she also produced an apportionment account dated 21 April 1999 prepared by Solicitors' Firm M for the sale of the Property by Company F (acting through the joint and several receivers) to Companies H, I and J on 23 April 1999. A copy of the apportionment account is attached hereto for reference. The purpose of the apportionment account was to deal with the payment of the amounts which were due upon completion to Company F as the vendor of the Property from Company H and the others as the purchasers and the owners of the Property and vice versa. Among those amounts payable by Company H and the others to Company F were two components of the Sum, the management fee deposit ($80,652) and the electricity deposit ($73,786).

36. By means of a written statement, Miss L gave evidence on the Taxpayer's behalf and explained the circumstances under which the Sum was incurred. She explained that the Sum of $169,717 comprised of three items: the owner's share of the public electric meter deposit of $73,786 which was paid to Company N when the Taxpayer first occupied the Property, the owner's share of the management fee deposit of $80,652 which was also paid to Company N when the Taxpayer first occupied the Property, and the Government rent for the period from 1 to 23 April 1999 which was paid to the Government of Hong Kong Special Administrative Region. It was explained that Company F as the legal owner and the landlord of the Property was legally responsible for all these three sums, although the public electric meter might have been registered in the name of Company N. It was also explained in her statement that Company N would normally treat the two items of deposits as a liability towards the registered owner for the time being of the Property and the right to recoup the deposits from Company N was passed onto the new owner of the Property when the Property was sold and the then vendor would recover the deposits from its purchaser. We were told that consequently when Company H and the others acquired the Property from Company F, on completion they had to pay Company F the two sums of deposits which appeared in the apportionment account, and pursuant to clause 3(a) of the Lease, the lessor, being Company F, was responsible for payment of the Government rent and the property tax on the Property. It was further explained that the Taxpayer paid those three items on behalf of Company F because they were included in the monthly debit note and quarterly rates assessment note together with the other outgoings such as monthly management fee, air-conditioning charge and rates which were payable by the Taxpayer as the lessee of the Property when it was demanded for payments by Company N and the Rating and Valuation Department. It was said that for practical reasons, the Taxpayer first settled these amounts and then sought reimbursements from Company F.

37. On the other hand, in its submission the Revenue drew our attention to the 'Amounts due from follow subsidiaries' as at 31 March 1993 which was $1,264,638 thus appearing to be made up of the initial rental deposit ($1,110,200), the management fee deposit ($80,652) and the electricity deposit ($73,786). Our attention was also drawn to the Taxpayer's accounts one year

later, that is, as at 31 March 1994 and the corresponding figure of the item of 'Amounts due from fellow subsidiaries' which had been reduced to $1,110,200. It was thus submitted by the Revenue that the reduction in the figure inferred that the management fee deposit and the electricity deposit had been repaid and were no longer due to the Taxpayer by 31 March 1994 and as such the two deposits should not be set off against the rent withheld for April 1999 and claimed for deduction in the year of assessment 1999/2000. Miss L was cross-examined as to whether the reduction was due to the repayment of the two deposits. She denied that the two deposits had been repaid. She suggested that the two deposits might have been re-classified under 'other receivables, prepayments or deposits'.

38. The evidence before us shows that the Taxpayer was not obliged to make payment of those three items which made up the Sum. Those three items fell within the responsibility of Company F. If the payment was made by the Taxpayer, it would be a loan from the Taxpayer to Company F and was not an expense or outgoing of the Taxpayer incurred in production of its chargeable profits and thus does not qualify as a deduction under section 16(1). Miss L gave evidence that the public electric meter deposit and the management fee deposit were paid to Company N when the Taxpayer first occupied the Property and the Government rent was paid to the Hong Kong Government, but she did not say when the Government rent was paid. No documentary evidence was produced to prove that such payments were indeed made by the Taxpayer. It was an assertion on the part of the Taxpayer. If indeed those two deposits were paid when the Taxpayer first occupied the Property and they were among the 'Amounts due from fellow subsidiaries' for the year ended 31 March 1993, it appears that they had already been repaid during the following year since the 'Amounts due from fellow subsidiaries' for the year ended 31 March 1994 was reduced by exactly the same amount as that represented the two deposits. While we said this, we have not forgotten Miss L's suggestion during cross-examination that the two deposits might have been re-classified as 'other receivables, prepayments or deposits'. But it was only a speculation on her part. It has not been proved as a fact. When we consider the evidence before us, doubts have arisen as to whether the Taxpayer had the opportunity to pay the two deposits on behalf of Company F to Company N when it first occupied the Property. According to Miss L, as a normal practice Company N did not reimburse the outgoing owner of the Property the two deposits each time when there was a sale of the Property but instead the outgoing owner would be reimbursed by the incoming owner upon completion and this method of reimbursement was achieved upon completion by way of payment according to the apportionment account between the outgoing owner and the incoming owner. Those who are familiar with properties transactions would also know that the aforesaid method of reimbursement of deposits is a common practice adopted by the management company and the vendor and the purchaser in a sale and purchase transaction. It was not unique to the transaction between Company F and Company H and the others. That being the case, it makes us wonder how the Taxpayer could have paid the deposits on behalf of Company F to Company N when it first occupied the Property, since the payment of the two deposits must have been made by Company F upon completion when Company F became the owner of the Property and the Taxpayer could only have become the lessee of the Property afterwards. Furthermore, as the usual practice adopted by Company N, the payment of the

deposits should have been made by Company F when it completed the purchase of the Property by way of reimbursement to the vendor and not to Company N direct. Thus, was it possible that the Taxpayer paid the two deposits to Company N on behalf of Company F together with the other monthly outgoings as alleged? Apart from the fact that there is no proof of payment of these deposits, there is also no proof of payment of the Government rent. Thus, in the absence of proof of payments, we are not satisfied that the Taxpayer had made payments of the Sum on behalf of Company F. Even if there were payments made (which we do not accept), those payments were loans to Company F and were not expenses incurred in production of the Taxpayer's chargeable profits and do not qualify as deduction under section 16(1).

Whether an expenditure of a capital nature?

39. Even if we were wrong in reaching our aforesaid conclusion that the Deposit and the Sum, if paid, were not expenses or outgoings to qualify as deductions under section 16(1) of the IRO and instead if they were the Taxpayer's expenses or outgoings, we find that they were expenses or outgoings of a capital and not of a revenue nature and thus were excluded for deduction under section 17(1)(c).

40. Section 17(1)(c) provides that no deduction shall be allowed in respect of 'any expenditure of a capital nature' or 'any loss or withdrawal of capital'. In the view of Chan J in Wharf Properties Limited v CIR 4 HKTC 310 at page 347, the section covers 'expenditure which is itself incurred as a capital and expenditure which, although not a capital in itself, is payment of a capital nature. If the expenditure is a capital payment, it is of course caught by the section. But even if it is not a capital payment, the Court has to consider whether it is of a capital nature or revenue nature'. Further, according to Chan J, in order to decide the question of whether an expenditure is of a capital or revenue nature, one has to examine not only the status or nature of the expenditure but also the reason or purpose for which and the circumstances under which it is incurred. None of the tests is decisive. The answer to the question depends very much on the facts of each case and ultimately it is 'common sense appreciation of all the guiding features' which would provide the answers.

41. We have been referred to the Wharf case for the various tests laid down in some previous decisions on the question of 'whether a particular payment or item of expenditure can be regarded as capital in nature'. The more important and common tests applied in the Wharf case were: (a) fixed or circulating capital test, (b) once and for all or securing expenditure test, (c) enduring benefit test, (d) profit yielding structure test and (e) the three matters considered by Dixon J in Sun Newspapers Limited & Associated Newspaper Limited v Federal Commissioner of Tax [1938] 5 ATD 87, that is, (1) the character of the advantage sought, (2) the manner in which it is to be used, relied upon or enjoyed and (3) the means adopted to obtain it.

42. The Revenue has made a detailed submission on the application of those tests to the facts of this case but we do not intend to repeat each and every application here. Needless to say,

we have carefully considered them and have taken them into account in reaching our determination that the payment of the Deposit and the Sum, if constituted an expenditure, was of a capital nature.

43. We agree with the Representative of the Taxpayer that a 'once and for all' payment can also be an expenditure attributable to revenue and not to capital. However, we fail to find that the expenditure in the present case was of a revenue nature.

44. The Representative contended that the object and effect of the payment of the Deposit was clear from the wording of clause 4 of the Lease which reads:

> ' 4. To secure the due payment of the said rent and the due performance and observance of the Tenant's conditions the Tenant has paid to the Landlord by way of deposit the sum of HONG KONG DOLLARS ONE MILLION ONE HUNDRED AND TEN THOUSAND TWO HUNDRED (HK$1,110,200.00) before the signing of this Lease (receipt whereof the Landlord doth hereby acknowledge and admit). Subject to prior forfeiture in accordance with Clause 5(a) hereof, the said deposit shall after the expiration or sooner determination of the said term hereby granted and provided that the said rent hereby reserved shall have been duly paid, the terms and conditions on the part of the Tenant to be observed and performed shall have been duly performed and observed by the Tenant and the Tenant shall have duly delivered to the Landlord vacant possession of the said premises in compliance with Clause 2(w) hereof, be returned to the Tenant without any interest within 14 days after the Tenant has delivered vacant possession of the said premises to the Landlord.'

It was submitted that the payment of rent was clearly of a revenue nature and thus the non-refund of a sum paid to secure the due payment of rent was similarly of a revenue nature and was not an 'expenditure of a capital nature or loss or withdrawal of capital' excluded for deduction under section 17(1)(c). In our view, to say that the payment of a rental deposit to secure the due payment of rent is equal to a payment of rent is a fallacy. Clause 4 of the Lease provided that the payment of the Deposit was made not only for the purpose of securing the due payment of rent but also for the due performance of the other terms and conditions under the Lease. It was also provided under clause 4 of the Lease that the Deposit would be returned to the Taxpayer after the expiration of sooner determination of the Lease if there was no breach of the terms of the Lease by the Taxpayer. Thus, it is clear from clause 4 that the reason or purpose for the payment of the Deposit was to bring into existence the Lease. By applying just the fixed or circulating capital test, it is clear that the payment was of a capital nature.

45. As quoted by Chan J in the Wharf case at pages 350 and 351 in Ammonia Soda Company v Chamberlain [1918] 1 ChD 286, Swinfen Eady LJ said:

> '*What is fixed capital? That which a company retains, in the shape of assets upon which the subscribed capital has been expended, and which assets either themselves produce income, independent of any further action by the company, or being retained by the company are made use of to produce income or gain profits ... In these cases the capital is fixed in the sense of being invested in assets intended to be retained by the company more or less permanently and used in producing an income. What is circulating capital? It is a portion of the subscribed capital of a company intended to be used by being temporarily parted with and circulated in business, in the form of money, goods or other assets, and which, or the process of which, are intended to turn to the company with an increment and are intended to be used again and again, and to always return with some accretion. Thus the capital with which a trader buys goods circulates; he parts with it, and with the goods bought by it intends to receive it back again with the profits arising from the resale of the goods. A bank lending money to a customer parts with its money, and thus circulates it, hoping and intending to receive it back with interest. He retains, more or less permanently, bank premises in which the money invested becomes fixed capital ...*'

In BD Australia Limited v Federal Commissioner of Tax [1965] 112 CLR 386, Lord Pearce said:

> '*Fixed capital is prima facie that on which you look to get a return by your trading operations. Circulating capital is that which comes back in your trading operations.*'

In the present case, to apply the fixed or circulating capital test and ask the question whether the expenditure was incurred in respect of fixed or circulating capital of the business, the answer to the question must be that it related to fixed capital and the expenditure was thus of a capital nature. The Deposit was paid to secure the Lease which was retained by the Taxpayer. The Lease enabled the Taxpayer to use the Property where the Taxpayer carried on its restaurant business. The Lease was not intended to return to the Taxpayer with an increment. The Lease was intended to be used by the Taxpayer to produce profits. Hence if the payment of the Deposit constituted an expenditure of the Taxpayer, it would be attributable to capital and not revenue and so was the write-off of the Deposit.

46. Since we have found that there was no evidence of payment of the Sum by the Taxpayer, the question of set-off of the Sum by the Taxpayer against the rent withheld does not arise. Even if the Sum was paid by the Taxpayer (which we do not accept), we are of the view that the payment was a loan to Company F and not an expenditure of the Taxpayer falling within section 16(1) of the IRO and thus does not qualify as a deduction. Further, even if it constituted the Taxpayer's expenditure, it was of a capital nature on the same basis of that of the Deposit and equally the set-off of the Sum against the rent withheld would be excluded for deduction under section 17(1)(c).

47. For the aforesaid reasons, we dismiss the appeal. However, we would record our appreciation of the careful and detailed submissions presented by the representatives of both parties.

APPORTIONMENT ACCOUNT

Vendor : [Company F] (acting through the joint and several Receivers)

Purchasers : [Company I],
[Company J] and
[Company H]

Re: [The premises at the commercial development of Housing Estate E]

Management Fee Deposit	HK$ 80,652.00
Share of Public Electric Meter Deposit	73,786.00
Sinking Fund	40,326.00
Insurance premium for the period from 26th March 1999 to 22nd October 1999 (i.e. HK$85,440.00 × 211/366)	49,256.00
	HK$244,020.00

LESS :-

Rent for the period from 24.4.99 to 30.4.99 (i.e. HK$621,712.00 × 7/30)	HK$145,066.00
Amount payable by the Purchasers to the Vendor	HK$ 98,954.00

Dated the 21st day of April 1999.

[SOLICITORS' FIRM M]