Case No. D66/88

Profits tax – deductions – interest – apportionment of interest expenses incurred to produce assessable and non-assessable profits – use of formula – s 16(1)(a) of the Inland Revenue Ordinance.

Panel: Henry Litton QC (chairman), Roland Chow Kun Chee and Jao Yu Ching.

Dates of hearing: 17 to 20 January 1989.
Date of decision: 1 February 1989.

The taxpayer company borrowed large sums from banks and incurred interest expenses. At the time they were made, borrowings were not ear-marked for any specific purpose. Some of the borrowed funds were used to make non-interest bearing loans to subsidiaries, offshore deposits and gold investments, none of which produced assessable profits to the taxpayer. Other funds were used to produce assessable profits. It was agreed that a portion of the interest paid by the taxpayer, being the portion attributable to the funds which were used to produce non-assessable profits, was not deductible for profits tax purposes.

The taxpayer could not provide sufficient information as to the source, period or purpose of each of its borrowings to enable such an apportionment to be made. The IRD accordingly used a formula which apportioned non-deductible interest expenses by reference to the ratio which the taxpayer's assets which produced non-assessable income bore to its total assets.

The taxpayer appealed, and argued that its assets which produced non-assessable profits were financed from sources other than its bank borrowings, such as dividend income, interest-free loans from subsidiaries and proceeds from the sale of investments. However, its evidence in this regard was unsatisfactory.

Held:

The use of the IRD's formula was justified.

(a) On the facts, it was impossible to identify the source and purpose of each of the taxpayer's borrowings. The only practicable basis for apportioning the interest expenses was to use the IRD's formula.

(b) The formula was not perfect as it was based on the assets held by the taxpayer at year-end. The formula therefore assumed that each asset had been held by

the taxpayer for the entire year. This would be disadvantageous to the taxpayer if it had held an asset which produced non-assessable income for only part of the year, but on the other hand it was an advantage to the taxpayer if the taxpayer had held an asset which produced assessable income for only part of the year. On balance, the formula was reasonable and appropriate.

(c) It was open to the taxpayer to demonstrate that specific borrowings were in fact attributable to assets which produced assessable income, and hence claim greater deductions than the formula would allow. However, evidence of such specific attribution requires more than an ex post facto reconstruction by someone who was not involved with the taxpayer at the relevant time.

Appeal dismissed.

[Editor's note: This decision can usefully be read in conjunction with D68/87, IRBRD, vol 3, 105 and D22/88, IRBRD, vol 3, 278.]

Wong Chi Wah for the Commissioner of Inland Revenue.
Anthony L Brown of Price Waterhouse for the taxpayer.

Decision:

Introduction

1.1 This is an appeal by a company against profits tax assessments for the years of assessment 1977/78 to 1984/85 whereby certain proportions of the company's claimed expenses by way of interest payments were disallowed by the assessor in the computation of assessable profits. It concerns the affairs of X Company (the company) for the period 1 April 1977 to 31 March 1985 (which forms the basis periods for the years of assessment in question).

1.2 Up to the year ended 31 March 1979, the company described itself as a 'trading company'. For the year ending 31 March 1980, the business was described as 'textile trading and investment holding'. From 1 April 1980 onwards, the nature of the business was described as 'investment holding'.

1.3 During the period in question (1 April 1977 to 31 March 1985), the group as a whole expanded and the number of subsidiaries of the company grew in a spectacular fashion. As at 31 March 1977, the company had 11 subsidiaries and 4 associates; as at 31 March 1985, the company had 52 subsidiaries and 11 associates. During the same period, the shares in subsidiaries and loans to subsidiaries grew as follows:

	31 March 1977	31 March 1985
Shares in subsidiaries	10,943,144	20,087,652
Loans to subsidiaries	16,115,282	150,462,801

1.4 During the 8 years in question, the company had a great many transactions with its subsidiaries and associates. In many instances, the inward and outward bills of the subsidiaries were taken up in the company's name and processed through the company's bank accounts. The company also advanced money to its subsidiaries. Collections of receivables were sometimes made on behalf of the subsidiaries. In this sense, the company acted as the 'banker' of the group.

1.5 It is common ground in this case that, during part of the period in question, the company had made investments in a number of assets which produced either no income or non-chargeable income. An example is as follows:

	31 March 1977	31 March 1983 $
Foreign deposits	Nil	73,811,660
Gold	Nil	11,910,516

1.6 In order to finance the very many transactions into which the company had entered during the period in question, the company had large borrowings from banks and paid in consequence substantial sums by way of interest. To the extent that the interest incurred in each of the basis periods is interest incurred in the production of chargeable profits, the company is entitled to deduct that as an 'outgoing and expense' in ascertaining the assessable profits for each year of assessment: section 16(1) of the Inland Revenue Ordinance.

The assessment

2.1 The profits tax returns of the company (which relied of course on the financial statements of the company for each of its financial years) did not identify the source of each borrowing of the company, nor the period of such borrowing, nor its purpose. Given the fact that in each year there would have been very many borrowings from different sources, for different periods, at different rates of interest and used for different purposes, it would have been virtually impossible to provide such information with the profits tax returns. And, of course, with the growth of the group from 1977 to 1985, the number of transactions with banks and with the company's subsidiaries and associates grew enormously. Thus, in order to ascertain the assessable profits of the company, the assessor had to find some formula for

determining what part of the interest payment was allowable as a deduction under section 16(1)(a) and what part was not allowable (because it was not paid by the company by way of interest on money borrowed for the purpose of producing chargeable profits). The formula used by the assessor in identifying the non-allowable interest was as follows:

$$\frac{\text{Non-assessable income producing assets}}{\text{Total Assets}} \times \text{total interest incurred}$$

2.2 In some cases, the 'non-assessable income producing assets' (which we will call hereafter 'non-chargeable assets' for short) would be readily ascertained from the company's returns: for example, the foreign deposits and gold referred to in paragraph 1.5 above. But, in the case of loans and advances to subsidiaries, the classification of the assets would not be so easy: some advances were interest-bearing, and some were not. Accordingly, there was much correspondence between the assessor and the company's tax representatives after the returns were lodged, in the course of which further information was provided by the company. Thus, by way of example, the assessor ascertained that, for the year ending 31 March 1980, the situation was as follows:

Name of subsidiary	Non-Interest bearing debt $	Interest bearing debt $
A Company	15,299	-
B Company	2,954,720	-
C Company	-	21,902,503
D Company	120	-
E Company	23,387,588	-
F Company	11,282,465	-
G Company	13,000,000	-
	50,640,192	21,902,503

The assessment was accordingly revised to reflect the position thus ascertained.

Objection to the assessments

3.1 It is worth mentioning, by way of background, that, in the early stages of the objections to the assessments, the company's tax representatives did not suggest that the use of the assessor's formula was in principle erroneous.

3.2 But, in the course of the correspondence with the assessor, it was also argued that some of the non-chargeable assets were sourced from dividends, non-interest-bearing loans from subsidiaries etc – which, if established, would to that extent tend to show that more of the bank loans (on which interest was incurred) were available to be used in the production of chargeable profits. Thus, it was argued for example that in the year ending 31 March 1978 (year of assessment 1977/78) an increase in loans to subsidiaries amounting to $12,000,000 was financed from (i) dividend income, (ii) interest-free advances from subsidiaries and (iii) proceeds from the sale of investments.

The tax representatives gave to the assessor a schedule of dividend income received from subsidiaries to substantiate the point. But when the point was further probed, it became obvious that the dividends could not possibly have been used to make up the advance of $12,000,000 to the subsidiary (G Company), since the advance to G Company was made in some instances earlier than the dates when the dividends were received. In those instances where the dividends were received by the company before the date of payment to G Company, the assessor discovered that those dividends went, not to make up the $13,000,000 loan to G Company, but to reduce the company's bank overdrafts.

And, as regards interest-free advances from subsidiaries (the alleged source of the advance to G Company), the assessor discovered that an alleged advance from E Company of $7,351,277 was merely the year-end balance owing to E Company and was not part of the $13,000,000 loan to G Company. (There might well have been some interest-free loan from E Company which went towards the $13,000,000 advance to G Company, but it certainly was not $7,351,277.)

We mention the facts canvassed in this paragraph to illustrate the point that some considerable effort was expended by the assessor to deal with the objections. When facts were put forward by the company's representatives suggesting that the assessments in accordance with the formula were excessive, they were carefully entertained by the assessor.

3.3 It is not clear to us why a point such as that summarised in paragraph 3.2 above was ever put forward by the tax representatives (apart from the proposition that the factual foundation was wrong) because it must have been apparent from the very inception of the tax objection that to attempt to identify the source and purpose of every loan made by the company was an utter impossibility in this case.

What, as far as we can ascertain, the tax representatives were attempting to do was this: if they were able to demonstrate that none of the non-chargeable assets were acquired (or sourced) from bank loans and other advances upon which interest was paid, it must follow that all the interest expenses incurred were likely to have been for the purpose of producing chargeable profits. In other words, if the increase in non-chargeable assets was

all funded by shareholders' funds and non-interest-bearing intercompany loans, then it must follow that the use of the assessor's formula was inappropriate and all the interest expenses incurred would have been deductible under section 16(1)(a). But it must have been apparent from the very beginning that this simply was not so. The facts plainly show that at least some of the bank loans must have been used in the acquisition of non-chargeable assets. In these circumstances, we do not see what purpose would have been served by demonstrating, for example, that the $13,000,000 advanced to G Company came from dividends, interest-free advances etc – unless it were possible to demonstrate that every other increase in non-chargeable assets came from a similar source. This was in fact not so in the case of the $12,000,000, and likewise not so in many other instances.

What the tax representatives succeeded in demonstrating was the opposite: that at least part of the loan of $13,000,000 to G Company came from bank overdrafts – on which interest was incurred which, for tax purposes, cannot be allowed as a deduction under section 16(1). It is regrettable that a point such as that summarised in paragraph 3.2 was ever taken by the tax representatives, for it made immensely complicated what should have been a relatively simple matter: the identification of non-chargeable assets, and the apportionment of interest expenses by reference to such assets.

'Appendix J'

4.1 Later on, and before the Commissioner had determined the objections lodged by the company against the assessments, the company put forward an alternative proposal for apportioning the interest. This proposal became incorporated in the determination as Appendix J and, together with the accompanying schedules, has been referred to at the hearing before us as Appendix J.

4.2 The relevant paragraphs of Appendix J read as follows:

'II PROPOSED BASIS OF SETTLEMENT

1. [not relevant]

2. [not relevant]

3. Through previous correspondence with your department, sufficient supporting evidence has demonstrated that the purpose or use of borrowed funds which would call for a disallowance of interest expense is that for the acquisition of 'non income-producing assets'. In this context, 'non income-producing assets' are collectively referring to the following:

   (i) Shares in subsidiary companies;

   (ii) Shares in associated companies;

(iii) Interest free loans/advances to subsidiary/associated companies;

(iv) Offshore deposits earning exempt interest income;

(v) Quoted and unquoted shares – Hong Kong and overseas;

(vi) Gold; and

(vii) Non interest-bearing current accounts with subsidiary/associated companies.

4. On the above premises, the accounting records of [the company] for the six years from April 1, 1977 to March 31, 1983 were reviewed with the objectives (i) to identify all acquisitions and disposals of non income-producing assets and (ii) to locate the source of funds for each acquisition and to segregate the interest-bearing fund from the non interest-bearing fund. As a result, the effect and calculation of proposed disallowable interest expenses for each year of assessment are put up in the attachments to this proposal.

In addition, a thorough review of [the company's] bank loans and accounts and an analysis of the purpose of all major drawdowns on a yearly basis were conducted (Exhibits III to VIII schedules (d)). These steps are additional safeguards to ensure that all drawdowns applied for the purpose of acquiring non-income producing assets have been dealt with.

III DETAILED BASIS OF CALCULATION AND EXPLANATORY NOTES

The principles and detailed basis of calculation adopted in the proposal are listed hereunder:

1. The definition of non-income producing assets ('NIPA') has been set out in II(3) above;

2. Interest Bearing Funds ('IBF') include bank loans, overdrafts, and interest-bearing accounts due to group companies;

3. Non-interest Bearing Funds ('NIBF') include available bank balances and non interest-bearing advances and balances on current accounts due to group companies.

4. Disallowable interest expense is calculated from the date of acquisition of NIPA until either:

(a) the NIPA is disposed of; or

(b) the IBF is repaid or replaced by self-generated funds or NIBF.

(In case the IBF is repaid by new borrowings (that is another form of IBF), interest on such new borrowings will be disallowed on the same basis).

5. Prevailing rates used for calculating disallowable interest expenses represent average bank prime rates prevailing during the respective years of assessment.

6. Wherever possible (that is when the overdraft or loan balance is equal to or less than the cost of NIPA), actual interest charged per bank statement is taken to obtain more accurate results.

7. Separate treatment is applied to non-interest bearing current accounts with group companies in view of the numerous transactions passing through these accounts. Notional interest is calculated on the monthly balance either due to or due from NEL and any net interest receivable by NEL on a notional basis for any year of assessment is deemed as disallowable interest expense. You may appreciate this calculation has the effect of treating the net advances to group companies as solely from the IBF. We propose to adopt this disadvantageous basis with a view to resolve the problem without further complications.

8. The calculations as mentioned in 7 above also demonstrate that the company had obtained substantial amounts of NIBF from its group companies, namely G Company and E Company, during the years of assessment.'

4.3 A large number of calculations then follow.

4.4 The Commissioner rejected the 'proposal' in Appendix J and upheld the assessor's formula as the most reasonable and appropriate in the circumstances of the case for the apportionment of the interest expenses.

The hearing before the Board of Review

5.1 At the hearing before us, a number of witnesses were called by the company's representative to testify on the company's behalf. The effect of such evidence was:

(i) to confirm that the company borrowed extensively for a variety of purposes: trading, investment, etc;

(ii) to confirm that these borrowings were never ear-marked for any specific purpose;

(iii) to show that, given the nature of the company's business and its relationship with its subsidiaries and associates, it was utterly impossible to tie up in each

instance either the Interest Bearing Funds ('IBF' in Appendix J) or the Non-Interest Bearing Funds ('NIBF' in Appendix J) with the various assets;

(iv) to demonstrate that the schedules to Appendix J do not comprehensively perform the function claimed in paragraph II (4) of Appendix J, namely '(i) to identify all acquisition and disposal of non income-producing assets and (ii) to locate the source of fund for each acquisition and to segregate the interest-bearing fund from the non interest-bearing fund'. (Since every loan to a subsidiary can come within the definition of a 'non-income producing asset' and every repayment of a loan a 'disposal', it can be readily seen that such an extravagant claim would have been met with the utmost scepticism, particularly as it is put forward as an ex post facto exercise, that is to say, a reconstruction (years after the event) of what the transactions might have been at the relevant time. The person who caused Appendix J to be prepared was not even an employee of the company during the relevant years.

5.2 Like the Commissioner, we place no reliance whatever on Appendix J. We cannot see how Appendix J begins to show that the assessments were in any way excessive or incorrect.

Conclusion

6.1 The reality of the situation is that, given the complexities involved in this case and the multiplicity of transactions, the company is totally unable to identify the specific sources of the various fundings. But bank borrowings were undoubtedly used to finance the acquisition of non-chargeable assets such as shares in subsidiaries. This was confirmed, in general terms, in the testimony of the company's general manager at the relevant times (and now the managing director).

In these circumstances it is difficult to see what other practicable basis there could be for apportioning the interest other than the formula adopted by the assessor. Obviously, the assessor's formula does not take into account the length of time for which an asset was held. The calculation is done on the year-end balance. The disallowance of interest is computed as if the non-chargeable assets were held for the whole year. This undoubtedly is disadvantageous to the taxpayer where the asset was acquired shortly before the year end. On the other hand, a non-chargeable asset might have been held for a larger part of the year and be disposed of shortly before the year end, in which case the taxpayer is benefited by the application of the assessor's formula.

6.2 The formula assumes that during each year the company applied a constant flow of funds for the acquisition of non-chargeable assets. This, of course, is a necessary assumption in applying the formula and may not match the reality of each and every specific instance. But, given the impossibility of identifying each and every application of funds, and the further impossibility of determining the period of each lending and borrowing, and the even further impossibility of ascertaining the rate of interest for the relevant borrowings,

it seems to us that the use of the formula is both reasonable and appropriate in terms of rule 2B(1) of the Inland Revenue Rules.

6.3 We should add for the sake of completeness that it was faintly argued before us that the whole of the interest expenses should be allowed on the basis that the company was carrying on a banking business. The proposition has only to be stated to demonstrate its absurdity, and in so far as it was put forward as a ground of appeal we reject it.

6.4 The company's appeal is dismissed and the assessments (as varied by the Commissioner) are confirmed.