

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D68/87

Assessments – past practice – whether assessor bound to past practice when making an assessment.

Profits tax – deductions – interest – apportionment of interest expense incurred to produce assessable and non-assessable income – whether formula appropriate – s 16(1)(a) of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Dr Richard Lee and Joseph Ming Lai.

Date of hearing: 12 January 1988.

Date of decision: 17 March 1988.

The taxpayer company carried on business in Hong Kong and abroad. In addition to using shareholders' funds, it borrowed money for the purpose of financing its business activities, which included the lending of money to subsidiaries and unrelated parties both in Hong Kong and abroad upon terms which resulted in the taxpayer receiving interest only some of which was taxable. Shareholders' funds and borrowings were also used to finance equity investments which produced dividend income which were exempt from tax. The taxpayer claimed deductions for the portion of the interest paid on its borrowings which was attributable to the receipt of taxable profits. In its accounts, however, the taxpayer did not designate particular funds as being used for particular purposes.

For the purpose of apportioning the interest, for some years the Commissioner had used a formula which was beneficial to the taxpayer. However, the Commissioner adopted a different formula for a subsequent year of assessment. This new formula 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. In computing total assets, the Commissioner disregarded investments in subsidiary companies.

The taxpayer claimed that the Commissioner was bound to use the previous formula. Alternatively, it claimed that the previous formula was preferable to the new formula.

Held:

The Commissioner was justified in using the new formula.

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- (a) The Commissioner was not bound to his past practice where that practice was incorrect.
- (b) Where the taxpayer's income consists of both assessable and non-assessable portions, and the taxpayer has not designated particular borrowings to particular investments and loans, it is appropriate for the Commissioner to adopt an artificial formula, provided such formula is reasonable and fair.
- (c) The new formula was fair although the Commissioner was being generous to the taxpayer in excluding investments in subsidiary companies from the formula. This amounted to an assumption that such investments were financed solely from shareholders' funds and not from borrowings. However, such concession was not in dispute before the Board.
- (d) In applying the formula, the Commissioner was entitled to take into account the average cost of funds and assets throughout the year. However, use of average figures might not always be justified. If the taxpayer were prejudiced by this method and could supply information so as to permit daily, monthly or other periodic calculations, this would be permitted.

Appeal dismissed.

Pauline Fan for the Commissioner of Inland Revenue.

An officer of the taxpayer company appeared for the taxpayer.

### Decision:

This appeal raises the interesting point as to how to apportion the interest expenses of a multi-national company which does not allocate specific funds to specific investments.

The facts so far as they are relevant can be briefly summarized as follows:

1. The Taxpayer was a Hong Kong public listed company.
2. The Taxpayer owned shares in subsidiary and associated companies in Hong Kong and elsewhere.
3. In addition to investing in the equity capital of the subsidiary and associated companies, the Taxpayer made interest-bearing loans to such companies and to third parties in Hong Kong and elsewhere.

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4. The Taxpayer financed its shareholdings in its subsidiary and associated companies and its loans by using its own shareholders' funds and also by itself borrowing moneys from third parties to whom it had to pay interest on the moneys borrowed.

5. In the accounts of the Taxpayer no distinctions were drawn between the sources of funds and the application of funds. The Taxpayer did not designate any particular source of funds as being used for any particular investment or loan. When making an investment in the equity of another company or when lending money the Taxpayer did not separately fund such investment or loan.

6. In prior years it had been agreed between the Taxpayer and the tax assessor that the interest expenses of the Taxpayer would be apportioned for Hong Kong tax purposes and part thereof disallowed on the basis of the following formula 'A':

$$\frac{\text{Overseas interest income}}{\text{Total income}} \times \text{Total interest expenses}$$

7. In respect of the year of assessment 1981/1982 the assessor decided not to follow the practice of the prior years and decided that it was more appropriate to compute the quantum of disallowable interest expenses by using the following formula 'B':

$$\frac{\text{Overseas interest income}}{\text{Total income}} \times \text{Total interest expenses}$$

8. The Taxpayer objected to this and the assessor then proposed a different formula 'C' as follows:

$$\frac{\begin{array}{l} \text{Average non-assessable income} \\ \text{producing assets (excluding} \\ \text{investment in subsidiary companies} \\ \text{as at 31 December 1980)} \end{array}}{\begin{array}{l} \text{Average total assets (excluding} \\ \text{investment in subsidiary companies} \\ \text{as at 31 December 1980)} \end{array}} \times \text{Gross interest expenses}$$

9. After much negotiation and dispute the matter came before the Commissioner for determination. The Commissioner determined that the appropriate formula for disallowable interest expenses should be formula C above.

### Disputed facts

The Taxpayer was represented at the hearing of this appeal by its Financial Controller. The somewhat lengthy statement of facts set out in the Commissioner's determination was not totally agreed by the Taxpayer and a separate statement of facts was prepared by the Taxpayer containing a number of amendments or additional facts. The

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Taxpayer did not call any witnesses to give evidence with regard to the statement of facts submitted by the Taxpayer. Some of the facts submitted by the Taxpayer were accepted by the Commissioner. As the onus of proof in a tax appeal is upon the taxpayer, in so far as the facts disputed or put forward by the Taxpayer were not agreed by the Commissioner, this Board finds in favour of the Commissioner. However with due respect to the Taxpayer it would appear that the relevant or underlying facts are not in dispute. This appeal had had a long history and it was apparent that both the Commissioner in the facts to his determination and the Taxpayer in the Taxpayer's statement of facts were recording or putting forward submissions which were disputed as well as the facts. The summary of facts which we have set out at the commencement of this decision are the relevant facts and were not in dispute. Other disputed matters, such as whether or not the assessor yielded to the Taxpayer's forcible argument relating to another matter, are not material to the subject matter now before the Board.

### Commissioner's inconsistency

At the hearing, the representative for the Taxpayer submitted that it was incorrect that the Commissioner should be inconsistent. Having decided to accept a formula in previous years, the Commissioner either should or is bound to adopt the same formula in subsequent years. We are not able to agree with this submission. Whatever the Commissioner or his assessor may have agreed in respect of previous years is not binding in relation to subsequent years. It is relevant to make reference to decisions in prior years in support of an argument that such previous decisions were correct and should be followed. However such previous decisions, if incorrect, would not be binding for future years.

The question for this Board now to decide is whether or not the formula used in previous years is the correct formula to be used in the current year or whether the formula set out in the Commissioner's determination is the appropriate formula, or indeed whether there is any other appropriate formula.

### Need to use a formula

In deciding whether or not an interest expense is an allowable expense to be off set or deducted against taxable income, the starting point must be section 16(1)(a) of the Inland Revenue Ordinance which then read as follows:

- '16(1) 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 –
- (a) sums payable by such person by way of interest upon any money borrowed by him for the purpose of producing such profits, and

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sums payable by such person by way of legal fee, procuration fees, stamp duties and other expenses in connexion with such borrowing;'

The relevant words of that sub-section are that the only interest which can be deducted is interest which is upon money borrowed for the purpose of producing such profits. Accordingly there must be a direct nexus between the interest and the profit.

We recognize that in the practical world of business and commerce it is not possible to designate each particular dollar of interest to each particular dollar of profit. A company has financial resources which comprise both shareholders' funds and borrowed moneys and from the deployment of these moneys the company earns its profits. If all of the profits earned are assessable to tax in Hong Kong then all of the interest payable would likewise be deductible even though it is not possible to show which interest dollar relates to which profit dollar.

In the present case we find a number of complications. The income of the Taxpayer comprises a mixture of dividends and interest. Dividends are not assessable to tax whereas interest is. However only part of the interest earned is assessable to tax because some was earned in Hong Kong and some offshore. We must also bear in mind that investments in the equity of a subsidiary or associated company may or may not earn income or receive dividends depending upon the nature of the underlying investment; however money invested by way of loan will immediately and always earn interest which accrues from day to day. It must also be borne in mind that the Taxpayer's sources of funds comprise its shareholders' funds which cost nothing and borrowed funds which cost interest.

Clearly some formula must be adopted which will be reasonable and fair for both the Taxpayer and the Commissioner. The Taxpayer has not allocated its shareholders' funds to long term equity investments and likewise has not attempted to designate the different moneys which it has borrowed amongst the different investments and loans which it has made, and some artificial formula must be found.

### Selection of the correct formula

The original formula A used by the assessor for prior years is clearly incorrect. This formula was based upon a relationship between overseas interest income and total income. There can be no direct relationship between interest income and total income because the latter includes dividends and income other than interest. It is also artificial because it only looks at income and not assets which produce income. The effect of this formula would be just as arbitrary as saying that one should simply deduct Hong Kong interest expenses and ignore overseas interest expenses.

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Likewise formula B is unacceptable because it ignores the existence of other income and the fact that moneys were invested in equities which did not produce assessable income but which nevertheless were paid for out of borrowed moneys.

It appears to us that the correct way of apportioning the total interest expenses is to do so on an investment or moneys invested basis as follows:

$$\frac{\text{Non-assessable income producing assets}}{\text{Total assets}} \quad \times \quad \text{Total interest expenses}$$

Thus one takes the total gross assets of the Taxpayer and splits them into assets which produce assessable income and assets which produce non-assessable income or no income. If this formula is used it assumes that the total interest expense of the Taxpayer has arisen as an overall cost of funds which is fair to all concerned. It then attributes part of those interest expenses to be off set against the taxable income of the Taxpayer in the ratio which the assessable assets bears to the total assets. In this way a cost of funds figure has been achieved and this cost of funds figure has then been applied to the funds which have been used to produce the assessable income. The formula takes into account that in determining the cost of funds it is necessary to blend shareholders' funds with no cost and borrowed moneys with interest costs. The formula also takes into account equity investments which do not produce assessable income and loans which produce assessable interest.

### Exclusion of investments in subsidiaries

In the present case the Commissioner has been more generous to the Taxpayer than would be the case if the formula which we have decided is appropriate were strictly applied. The Commissioner has conceded that investments in subsidiary companies as at 31 December 1980 (being the commencement of the period in question) should be excluded from the formula. In effect the Commissioner is saying that all investments in subsidiary companies prior to the period in question were made by the Taxpayer out of the shareholders' funds of the Taxpayer. As this concession is in the favour of the Taxpayer and as the Commissioner has not sought at the hearing of the appeal to vary the formula in his Determination, we agree on the facts before us that the investments in subsidiary companies as at 31 December 1980 should be excluded from the calculation.

### Use of average figures

The representative for the Taxpayer submitted that it was wrong to assume that there was an average cost of funds throughout the year in question and that there were average total assets. Here again we cannot agree with the Taxpayer's submission. During the year in question the Taxpayer was continuously borrowing, investing and lending moneys. It was an ongoing process.

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There are two ways of approaching the matter. One is to account strictly on a day to day or month by month basis and the other is to do as the Commissioner has done, namely take an opening and closing balance and average the amounts equally throughout the year. Clearly in many cases it would be inappropriate to adopt the average method.

However in the present case we have been provided with a list of the investments and loans made by the Taxpayer in the year in question. These comprised three equity investments and one loan. The loan was made at the beginning of the year and accordingly would have been earning interest throughout the year. On the other hand the equity investments were made in May and July of the year. Taking the arithmetical average for the year would tend to benefit the Taxpayer, but even if it did not we consider that on the facts before us it is appropriate to adopt the arithmetical average for the year. The Taxpayer did not produce any evidence to show that it was prejudiced by taking the average and did not submit the facts necessary to carry out any other form of apportionment. It would not be practical to try in this case to make actual daily, monthly or other periodic calculations.

For the reasons given we find in favour of the Commissioner and dismiss this appeal.