INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D68/90

Profits tax – whether transactions should be disregarded under section 61 of the Inland Revenue Ordinance.

Panel: Howard F G Hobson (chairman), Robert Kwok Chin Kung and Norman J Gillanders.

Dates of hearing: 12, 13 and 14 November 1990.
Date of decision: 13 February 1991.

The taxpayer was established in Hong Kong as a partnership between two limited companies but for practical purposes was owned and controlled by one of the partners only. A complex series of transactions was made which included the taxpayer purporting to borrow money from an associated company. The taxpayer and all companies involved were owned and/or controlled within the same group. It was claimed by the taxpayer that it had incurred interest expenses which should be deductible for tax purposes in Hong Kong. The assessor disallowed the expenses on the ground that they were artificial and should be disallowed under section 61 of the Inland Revenue Ordinance. The taxpayer appealed to the Board of Review.

Held:

It was permissible to look at the surrounding transactions to find out whether there was any commercial reasons for the transactions. In the present there was no commercial reason and the transactions should be disregarded for all purposes. It was also decided that the two partners were persons concerned within the meaning of section 61.

[Editor's note: The taxpayer has filed an appeal against this decision.]

Cases referred to:

Lo & Lo v CIR [1984] 2 HKTC 34
Federal Commissioner of Taxation v Walker 84 ATC 4553
IRC v Europa Oil (NZ) (No 1) [1971] AC 772
Europa Oil (NZ) Ltd v IRC (No 2) [1976] 1 All ER 503
Mangin V CIR 70 ATC 6001
Magna Alloys & Research Pty Ltd v Federal Commissioner of Taxation 80 ATC 4542
CIR v Swire Pacific Ltd [1979] 1 HKTC 1145

CEC v Comptroller of Income Tax [1950-1985] MSTC 551
D52/86, IRBRD, vol 2, 314
CIR v Douglas Henry Howe [1977] 1 HKTC 936
Seramco Ltd Superannuation Fund Trustees v Income Tax Commissioner [1977] AC 287
Kum Hing Land Investment Co Ltd v CIR [1967] 1 HKTC 301
CIR v Rico International Ltd [1965] 1 HKTC 229
CIR v Hang Seng Bank Ltd (PC) [1990] 2 WLR 1120
W T Ramsay v IRC (HL) [1981] STC 174
W T Ramsay v IRC (CA) [1979] STC 582
CIR v County Shipping (CA) 3 HKTC 267
Cairns v MacDiarmid 56 TC 556
Overseas Containers (Finance) v Stoker (Inspector of Taxes) [1989] STC 364
CIR v Challenge Corporation [1986] STC 548
F&C Donebus Pty v Federal Commissioner of Taxation 19 ATR 1521
Federal Commissioner of Taxation v Gulland [1985] ATC 1
Furniss v Dawson [1984] STC 641
The Commissioners of Inland Revenue v The Duke of Westiminster [1936] AC 1

E C D'Souza for the Commissioner of Inland Revenue.
Chua See Hua of Ernst & Young for the taxpayer.

Decision:

This decision concerns an appeal by the Taxpayer against a profits tax assessment for the year 1985/86 on the ground that an amount of $6,300,000 was wrongly disallowed in the computation of the Taxpayer's taxable profits.

1. PRIMARY FACTS

The following facts are largely taken from the determination of the Deputy Commissioner of Inland Revenue. They were not disputed by Ms Chua though she submitted that in so far as any particular fact does not directly involve the Taxpayer it is irrelevant.

1.1 The Taxpayer was established in Hong Kong in 1986 as a partnership between X Limited ('X Ltd') (99%) and Y Limited ('Y Ltd') (1%). In its application for registration of business in 1986 the nature of the business carried on by the Taxpayer was described as 'investment'.

1.2 At all relevant times, A Limited ('A Ltd'), a private company incorporated in Hong Kong, was the ultimate holding company of a corporate group and beneficially wholly owned B Limited ('B Ltd') and Y Ltd which are non-Hong

Kong incorporated companies. A Ltd also held indirectly, through B Ltd, 100% of the ordinary shares in X Ltd, also a non-Hong Kong incorporated company.

1.3 In 1986, agreements were entered into to the following effect:

1.3.1 Pursuant to a sale and purchase agreement ('S&P agreement') Y Ltd agreed to purchase from X Ltd certain Hong Kong properties – namely a house for $1,250,000, a flat and car park space for $800,000, commercial premises for $69,563,952 and furniture and fittings for $721,884 – for a total price of $72,335,836.

1.3.2 By four separate agreements:

(a) Y Ltd was to borrow a sum not exceeding US$9,000,000 from A Ltd ('A/Y loan agreement');

(b) A Ltd was to borrow a sum not exceeding US$9,000,000 from the Taxpayer ('Taxpayer/A loan agreement');

(c) The Taxpayer was to borrow a sum not exceeding US$9,000,000 from B Ltd ('B/Taxpayer loan agreement'); and

(d) B Ltd was to borrow a sum not exceeding US$9,000,000 from X Ltd ('X/B loan agreement').

1.4 The S&P agreement provided for completion on or before 31 March 1986. There is no requirement for a deposit but in other respects the agreement is fairly typical of an arm's length contract for the sale and purchase of property. We were not shown the assignment of title but assume it qualified for relief from ad valorem duty under section 45 of the Stamp Duty Ordinance.

1.5 The A/Y loan agreement contained, inter alia, the following provisions which we quote verbatim with our comments in square brackets:

> ' "drawdown period" means the period from the date hereof [11 March 1986] and ending at 4:30 pm (local time of lender) on 31 March 1986;
>
> "lender" includes an assignee, being a person entitled to be paid the loan and/or interest amount due to be paid to him and all other rights and benefits hereunder;
>
> "loan" means the sum of US$9,000,000 or a lesser amount made available by the lender to the borrower;

Clause 3	The proceeds of the loan will be used by the borrower for the purposes of acquiring an income producing property at [the commercial premises referred in paragraph 1.3.1 above]; …
	…
Clause 6	The borrower shall subject to any prepayment being made in accordance with clause 7 hereof repay the loan in full on 31 March 1990; …
Clause 7	The borrower shall not be entitled to prepay the loan … without the written consent of the lender …;
Clause 8(1)(a)	Subject to 8(2) hereof, the borrower shall pay interest on the loan in the following amounts on the following respective dates where the drawings amount to US$9,000,000 …
	[Comment: As the drawing was less than that amount this provision is irrelevant];
Clause 8(1)(b)	Where the drawings amount to less than US$9,000,000, subject to clause 8(2) and hereunder, the borrower shall pay interest on the loan half-yearly during the term of the agreement at the rate of 10% per annum or at such other rate specified by the lender in writing … Provided that such rate shall not exceed 15% per annum. The first interest payment is due on 30 September 1986 and interest payment is due half-yearly thereafter.
	The initial interest amount shall be the amount in Hong Kong dollars calculated as follows:
	$9{,}000{,}000 \times \frac{10}{100} \times \frac{\text{Relevant number of days}}{365}$
	where the relevant number of days is the number of days from and including the date of the drawing to and including 30 June 1986 [sic].

[Comment: This reference to 30 June 1986 is incompatible with the preceding '30 September 1986' and 'half-yearly' provisions. Furthermore the underlined words (added to the original text) confuse the reference to 'initial interest amount' which in 8(1)(a)(which should not apply) refers to 31 March 1986.]

Clause 8(2)(a) The lender may be not less than three business days' notice in writing demand that interest on the loan as stipulated in clause 8(1) hereof be PREPAID in advance for any number of days and not more than four hundred days of the due date as stipulated in clause 8(1).

[Comment: As 8(1)(a) did not apply, the aforesaid stipulation is presumably a reference to clause 8(1)(b) where the due date is half-yearly. Also presumably 'the due date' is intended to mean a due date for the payment of interest, not principal. Moreover to treat 'the due date' as meaning the next interest payment date would confine the prepayment to half a year's interest which would be incompatible with the reference to four hundred days.]

Clause 8(2)(b) In the event that the lender demands interest as stipulated in clause 8(1) hereof to be prepaid under paragraph (a) above, the borrower shall be required to pay the interest as calculated in paragraph (c) hereof of the total amount of interest otherwise payable to the lender the date upon which the lender requires the prepayment of interest. (sic)

[Comment: The syntax is confused.]

Clause 8(2)(c) The amount of interest to be prepaid under clause 8(2)(a) shall be equal to 90% of the total amount of interest otherwise payable to the lender the date which the interest is due and payable under clause 8(1) where interest is not prepaid for less than (thirty) days (sic).

[Comment: The syntax is confused.]

…

Clause 8(4) The lender shall be entitled, by written notice to the borrower at any time prior to any date on which interest is payable as specified in clause 8(1) and/or 8(2), to require the borrower to issue a promissory note or a number of promissory notes in such amount as designated by the lender in respect of and evidencing the liability of the borrower for such interest on such date such promissory note to be in the form set out in the schedule hereto or such other form as may be agreed at the time. For avoidance of doubt, in the event that any promissory notes are issued as aforesaid, the borrower's obligation under this agreement to pay interest in respect of the period from which such promissory note is issued shall forthwith terminate.

[Comment: Again confusing syntax.

'such date' implies a prior reference to the word 'date' – the only such prior reference is to any date on which interest is payable that is (a) 30 September and 31 March each year or (b) if 8(2) is invoked the date for payment stipulated in the prepayment notice. Whilst the meaning is rather uncertain for (a) it is fairly clear for (b). We were not shown any notice invoking this clause 8(4), see paragraph 1.9.1 below.]'

The underlined words in the above quoted provisions were obviously added to the original text.

1.6 The Taxpayer/A and the B/Taxpayer loan agreements contain all the foregoing provisions in exactly the same terms [including the purposed terms in clause 3 though the evident intention of both A Ltd and the Taxpayer was to on-lend].

All the aforesaid agreements contain a provision for calling in the loan 'and other amounts payable hereunder' if the borrower 'makes default in the payment on due date of any moneys when and as the same ought to be paid …'

1.7 The X/B loan agreement differs from the text of the agreements referred to at paragraph 1.5 above in the following respects:

(a) It did not contain the above inclusive definitions of 'lender';

(b) Clause 3 reads 'The proceeds of the loan will be used by the borrower for its general corporate purposes';

(c) There is no prepayment provision – although the repayment clause 6 opens with 'Subject to prepayment';

(d) Clause 7 says 'The borrower shall borrow the amount free of any interest but subject to any mutual agreement that may be entered after the date of this agreement'; and

(e) There are no provisions similar to clause 8.

1.8 Except for B Ltd, whose address is in USA, the addresses of the lenders and borrowers are the address of the commercial premises referred to in paragraph 1.3.1 above.

1.9.1 On 17 March 1986, before drawdown, B Ltd gave notice to the Taxpayer in the following terms:

> ' In accordance with clause 8(2) … you are requested that interest on the loan as stipulated in clause 8(1) be prepaid for 365 days from the date of your drawing calculated in terms of clause 8(2) as follows:
>
> | Borrowing | | Interest Rate | | | | |
> |---|---|---|---|---|---|---|
> | US$8,974,359 | x | 10% | x | 90% | = | US$807,692.31 |
>
> Please pay the amount to our account with [the bank] on or before 31 March 1986.'
>
> [Comment: This notice does not call for the issue of a promissory note.]

1.9.2 On the same day the Taxpayer gave notice to A Ltd requiring A Ltd to prepay five days interest at 10%, amounting to US$12,294 'from the date of your drawing …' to be paid to the bank on or before 31 March 1986.

[Comment: The reference to 10% conforms with the 'less than (thirty) days' in clause 8(2)(c).]

1.10 On 23 March 1986, that is before drawdown, the Taxpayer drew a promissory note having face value of US$807,692.31 ('P/N amount') in favour of B Ltd payable on 26 March 1986. It is accepted that the P/N amount is equivalent to

$6,300,000 and represents the prepaid interest referred to at paragraphs 1.9.1 and 1.13.2 and 1.13.3.

1.11 On 25 March 1986, that is before drawdown, A Ltd [according to the Taxpayer's bank statement] transferred US$12,294 to the Taxpayer's account in the bank which amount is shown as a credit on the same day in the Taxpayer's account. (A Ltd's bank statement, refers to paragraph 1.13.4 below, only shows the loan coming in and going out – we assume A Ltd paid US$12,294, the interest referred to at paragraph 1.9.2 above, out of another account.)

1.12 Having received the Taxpayer's promissory note B Ltd then endorsed it over [date not shown], without recourse, to the USA branch of the bank which somehow caused B Ltd's account with the bank in Hong Kong to be credited with US$805,092.30 (the discounted amount that is US$2,600 less than the P/N amount) on 26 March. The USA branch of the bank endorsed the promissory note over to the bank in Hong Kong [date not shown] and on 26 March B Ltd advanced the discounted amount to the Taxpayer which used that sum plus US$2,600 of its own money to pay the bank in Hong Kong the P/N amount of US$807,692.31 on the same day (see paragraphs 1.13.2 and 1.13.3 below).

[Comment: The Deputy Commissioner treated B Ltd's advance to the Taxpayer of the discounted amount as a loan – this was not disputed by the Taxpayer's representative. However we do not know whether it was free of or subject to interest.]

1.13 On 26 March 1986, the following transactions appear from US dollar bank statements [the order in which they are set out here does not thereby reflect the appropriate order, however the loan circuit had to begin with the introduction of money and X Ltd's account is the only account which starts by being overdrawn, the remainder either had no or inadequate credit balances].

1.13.1 X Ltd's account, which starts with a nil balance, is <u>first debited</u> [thereby implying an overdraft] with US$8,974,359 (the loan – which both representatives agree is equivalent to $70,000,000) going out then credited with it coming in: it is accepted that this credit is a receipt of part of the $72,335,836 purchase price due from Y Ltd. The names of the transferor and transferee are not shown – merely codes – however (a) the debit entry code coincides with a credit entry of the same amount in B Ltd's account and (b) though the code for the credit entry is unhelpful Y Ltd's account (see paragraph 1.13.5 below) shows a transfer of US$8,974,359 from Y Ltd to X Ltd on 26 March. As these are the only two transactions in X Ltd's statement there is a nil balance.

1.13.2 B Ltd's account shows the loan as received and it is evident on comparing this statement with the one at paragraph 1.13.1 above that this is the debit in X Ltd's

statement. The loan is then debited on transfer to the Taxpayer. The statement also credits US$1,000 received from A Ltd and US$805,092.30 (the discounted amount) as a credit transfer [though the transferor is not named it must be the USA branch of the bank] which is then debited on transfer out to the Taxpayer leaving a balance of US$1,000.

1.13.3 The Taxpayer's account (as regards 26 March) shows credits of the loan and the discounted amount both received from B Ltd and debits of US$807,692.31 (the P/N amount) [though the transferee is not shown it is evidently the bank in Hong Kong] and the loan which is shown as transferred to A Ltd. This account also shows US$1,000 received from Y Ltd.

[Comment: We note that according to the order of the debits the bank in Hong Kong gets paid the P/N amount before it passes the loan to A Ltd.]

1.13.4 A Ltd's account is credited with the loan received from the Taxpayer and debited with it on transfer to Y Ltd.

1.13.5 Y Ltd's account is credited with the loan and debited with a transfer of US$8,974,359 to X Ltd – see paragraph 1.13.1 above. As mentioned it is accepted that this debit entry is payment on account of the $72,335,836 payable to X Ltd under the S&P agreement and that the $2,335,836 balance of the purchase price was to be treated as due to X Ltd in Y Ltd's current account with X Ltd. Y Ltd's bank statement also shows US$1,000 received from A Ltd and transferred out to the Taxpayer. There is then a nil balance.

[Comment: From paragraph 1.13 above it will be seen that the loan which started off as an advance from X Ltd to B Ltd came back to X Ltd on the same day in the form of part payment of the purchase price. As no explanation was offered regarding the US$1,000 transfers we have treated them as irrelevant.]

1.14 On 29 October 1986 (that is after 30 September 1986 [which is the first interest payment date – except arguably for the 'initial payment date' on 31 March 1986 – for both the Y Ltd loan and the A Ltd loan]) the following assignments were executed:

1.14.1 An assignment ('the first assignment') whereby A Ltd assigned the loan (specifically 'all payments due to it') owing to it by Y Ltd ('the Y Ltd debt') under the A/Y loan agreement to the Taxpayer in settlement of the loan owed by A Ltd to the Taxpayer under the Taxpayer/A loan agreement.

[Comment: We take 'all payments due to it' to include interest.]

1.14.2 An assignment ('the second assignment') whereby the Taxpayer, in consideration of US$9,763,119.10 ('the consideration') assigned on its rights

to 'all payments' under the Y Ltd debt, to B Ltd. The consideration was to be set off against the loan owing to B Ltd (that is US$8,974,359) by the Taxpayer under the B/Taxpayer loan agreement and the balance (US$788,760.10) of the consideration was to 'remain as an amount payable' to the Taxpayer by B Ltd.

[Comment: There is no mention of this set off amount attracting interest nor of B Ltd's loan of the discounted amount to the Taxpayer – see paragraph 1.12 above.]

1.15 The Taxpayer declared in its profits tax return for 1985/86 (with accounts attached – the 1986 accounts) a loss of $6,203,873 which was arrived at as follows:

Interest received (from A Ltd US$12,294)	$96,127
Less: Interest expense (that is P/N amount)	6,300,000
Loss for the year	($6,203,873)

Calculation of Interest Expense

Interest from 26 March 1986 to 26 March 1987

US$8,974,359 x 10% per annum x 90%	US$807,692
Equivalent to	$6,300,000

1.16 In its own tax return for 1985/86 X Ltd itself invoked section 19C(5) of the Inland Revenue Ordinance to set off its share of the Taxpayer's alleged loss, $6,141,834 (that is 99% x $6,203,873) against its assessable profits ($8,143,921).

[Comment: At the then current rate of 18.5% the set off would save X Ltd $1,136,239.29 in tax.]

1.17 After the assignment of the Y Ltd debt to B Ltd under the second assignment the Taxpayer became dormant.

1.18 The assessor did not accept the Taxpayer's return at paragraph 1.15 above and raised the following profits tax assessment:

Year of Assessment 1985/86

Loss per return	($6,203,873)
Add: Interest expense	6,300,000
Assessable profits	$96,127
Tax payable thereon	$17,783

1.19 Following objection by the Taxpayer the Deputy Commissioner confirmed this assessment.

2. DEPUTY COMMISSIONER'S REASONS

2.1 It is worth summarizing the reasons given by the Deputy Commissioner for upholding the assessment.

2.1.1 The issue for determination is whether the prepaid interest expense (that is the P/N amount) should be allowed as a deduction form the Taxpayer's taxable profits. Insofar as relevant, section 16(1)(a) and (2)(c) stipulate that interest upon money borrowed is deductible if the sums payable by way of interest are chargeable to tax under section 16 which provides that deductions shall be allowed for all outgoings and expenses, including interest expense, to the extent to which they are incurred in producing chargeable profits.

2.1.2 Section 16(2)(c) had obviously not been satisfied since the interest payable by the Taxpayer by way of a promissory note was not chargeable to tax in the hands of B Ltd. (B Ltd does not carry on business in Hong Kong, it is not a taxpayer). How the P/N amount was subsequently disposed of by B Ltd is not a relevant factor to be considered for the purposes of section 16(2)(c).

2.1.3 The loan on which the interest was paid was not borrowed by the Taxpayer for the purpose of producing chargeable profits because the Taxpayer had agreed to borrow from B Ltd and the lend to A Ltd at the same rate of interest.

2.1.4 Section 61 empowers the assessor to disregard artificial or fictitious transactions which reduce or would reduce the tax payable by a person.

2.1.5 However the Deputy Commissioner did not consider that he needed to address the points at paragraphs 2.1.2 and 2.1.3 above in detail as his conclusion was that the transactions entered into by the Taxpayer could be disregarded under section 61.

2.2 In coming to the conclusion that the transactions were artificial or fictitious, the Deputy Commissioner took into account the following:

(a) The formation of the Taxpayer by X Ltd and Y Ltd involved the establishment of a partnership of no commercial substance with the only attribute of having a potentially allowable loss arising form prepaid interest expense which would be available for set off for profits tax purposes;

(b) The complete 'round-robin' of funds occurring on 26 March 1986 as reflected in the bank statements;

(c) The fact that no real cash funds appeared to have subsisted;

(d) The US$688,760 gain made when effecting the second assignment represented a refund of the interest expense;

(e) The apparent lack of any commercial reason for the interposition of the Taxpayer in the chain of transactions other than for its potential to have allowable loss available for set off against the assessable profits of X Ltd;

(f) The absence of any explanation of the commercial reality of the Taxpayer having to prepay one year interest to B Ltd and at the same time having to borrow from B Ltd a sum equal to the discounted amount;

(g) The absence of any explanation of the commercial reality of the need to execute the assignments;

(h) The absence of any explanation of the commercial reality of pricing the assignment of Y Ltd's debt at US$8,974,359 when assigned by A Ltd to the Taxpayer and at US$9,763,119 when the Taxpayer assigned it onto B Ltd;

(i) Neither the B/Taxpayer loan nor the Taxpayer/A loan could possibly have generated any profit to the Taxpayer;

(j) The immediate dormancy of the Taxpayer after the execution of the second assignment.

3. GROUNDS OF APPEAL

The grounds of the appeal before us may be summarized as follows:

3.1 The $6,300,000 (equal to the P/N amount) was deductible as an expense under section 16(1) of the Inland Revenue Ordinance either:

(a) because it was an expense, simpliciter, incurred in the production of profits.

or

(b) because it was 'interest', incurred in the production of profits, within the meaning of section 16(1)(a) since it satisfied the condition laid down in section 16(2)(c) because the principal was borrowed from B Ltd, which the Deputy Commissioner conceded was neither a financial institution nor an overseas financial institution, and the 'interest paid was chargeable to tax under the Inland Revenue Ordinance'. [meaning – in the hands of the bank].

3.2 None of the disallowable deductions set out in section 17 have any application to the $6,300,000.

3.3 Section 61 does not apply.

4. EVIDENCE

4.1 No witness gave evidence. Apart from the relevant documents referred to in the facts at paragraph 1 above (copies of all of which, other than evidence of the Taxpayer partnership and the assignment of X Ltd's title to the properties to Y Ltd, were produced to us), further relevant papers were produced and admitted into evidence without challenge.

4.2 Ms Chua acknowledged that whereas A Ltd, Y Ltd and X Ltd carried on business in Hong Kong and the Taxpayer registered itself as an investor partnership in 1986, B Ltd did not carry on business in Hong Kong.

5. RELEVANT LEGISLATIVE PROVISIONS AND CITED CASES

5.1 The material parts of the pertinent sections read as follows:

'14. 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 form such trade, profession or business (excluding profits arising form the sale of capital assets) as ascertained in accordance with this Part [profits tax].

…

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) where the conditions set out in sub-section (2) are satisfied, sums payable by such person by way of interest upon any money borrowed by him for the purpose of producing such profits, and sums payable by such person by way of legal fees, procuration fees, stamp duties and other expenses in connection with such borrowing;

…

16(2) The conditions referred to in sub-section (1)(a) are that-

…

(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;

…

61. Where an assessor is of opinion that <u>any transaction</u> which reduces or would reduce the amount of tax payable by any person <u>is artificial</u> or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessable accordingly.'

5.2 The following lists the cases produced though not all of them were specifically dealt with.

1. <u>Lo & Lo v CIR</u> [1984] 2 HKTC 34

2. <u>Federal Commissioner of Taxation v Walker</u> 84 ATC 4553

3. <u>IRC v Europa Oil (NZ)</u> (No 1) [1971] AC 772

4. Europa Oil (NZ) Ltd v IRC (No 2) [1976] 1 All ER 503

5. Mangin V CIR 70 ATC 6001

6. Magna Alloys & Research Pty Ltd v Federal Commissioner of Taxation 80 ATC 4542

7. CIR v Swire Pacific Ltd [1979] 1 HKTC 1145

8. CEC v Comptroller of Income Tax [1950-1985] MSTC 551

9. D52/86, IRBRD, vol 2, 314

10. CIR v Douglas Henry Howe [1977] 1 HKTC 936

11. Seramco Ltd Superannuation Fund Trustees v Income Tax Commissioner [1977] AC 287

12. Kum Hing Land Investment Co Ltd v CIR [1967] 1 HKTC 301

13. CIR v Rico International Ltd [1965] 1 HKTC 229

14. CIR v Hang Seng Bank Ltd (PC) [1990] 2 WIR 1120

15. W T Ramsay v IRC (HL) [1981] STC 174

16. W T Ramsay v IRC (CA) [1979] STC 582

17. CIR v County Shipping (CA) 3 HKTC 267

18. Cairns v MacDiarmid 56 TC 556

19. Overseas Containers (Finance) v Stoker (Inspector of Taxes) [1989] STC 364

20. CIR v Challenge Corporation [1986] STC 548

21. F&C Donebus Pty v Federal Commissioner of Taxation 19 ATR 1521

22. Federal Commissioner of Taxation v Gulland [1985] ATC 1

6. TAXPAYER'S SUBMISSIONS

6.1 Ms Chua argued that since the Taxpayer factually received interest of US$12,294 ($96,127) from A Ltd for the five days from 26 March 1986 to 31

March 1986 clearly the Taxpayer had incurred the P/N amount (hereafter sometimes the 'claimed expense') as an expense in the production of profits as contemplated by section 16(1). Moreover the expense, when treated as 'interest', meets the criteria laid down in section 16(2)(c) of the Ordinance because the claimed expense was paid to the bank in Hong Kong.

6.2 Although section 16(1) uses the words 'where the conditions set out in sub-section (2) are satisfied', Fuad V-P in the County Shipping case is authority to the effect that it is sufficient if only one of the conditions is satisfied. At page 13, 'It is absolutely clear that paragraphs (a) to (f) of sub-section (2) of section 16 are disjunctive'. As regards 16(2)(c) we were urged to note that it does not restrict the party to whom interest is paid to the lender: it is sufficient that the interest be chargeable to tax under the Ordinance. In that regard it is reasonable to assume that the bank in Hong Kong, the recipient of the P/N amount, so far as its Hong Kong operations are concerned, is a taxpayer and consequently pays tax on its profits and that 'the interest' (sic) the bank received, when the Taxpayer redeemed the P/N amount on 26 March 1986, was eligible to tax.

6.3 Reference was then made to the comments of Lord Brightman in the Lo & Lo Privy Council decision to the effect that though the word 'outgoings' covers sums actually paid by the taxpayer, an 'expense' incurred includes a sum in respect to which there is an obligation to pay.

6.4 Whether the P/N amount was incurred in the production of profits is a question of fact. Ms Chua said that the judgment in Magna Alloys addressed the question of how far 'purpose' was relevant to an Australian legislative provision similar to section 16 and concluded that given a sufficient identification of what the expenditure was for, and the character and scope of the taxpayer's income earning undertaking or business, that question whether expenditure in incurred for the purpose of carrying on a business or for the purpose of gaining or producing assessable income 'does not depend upon the taxpayer's state of mind'. The relationship between what the expenditure is for and the taxpayer's undertaking or business determines objectively the purpose of the expenditure.

6.5 Reference was made to a passage by Fisher J in the Walker decision. 'The purpose which the partners had in mind in entering into the partnership is not the relevant consideration. The purpose for which the outgoings were incurred is a matter of objective determination.'

6.6 Our attention was drawn to the Privy Council decision in Europa Oil (No 2) concerning New Zealand legislation providing for the deduction of expenditure or loss incurred in the production of assessable income. The following appears at page 508 – 'it is not the economic result sought to be obtained by making the expenditure that is determinative of whether the expenditure is deductible or

not, it is the legal rights enforceable by the taxpayer that he acquires in return for making it'. And in Europa Oil (No 1) at page 772 per Lord Wilberforce '… taxation by end-result or economic equivalence is not what the section (an anti-tax avoidance provision) achieves'.

6.7 Neither the fact that the Taxpayer, B Ltd and A Ltd are related nor that the borrowings and on-lendings were at the same rate should preclude deductibility.

6.8 Swire Pacific is clear authority for the proposition that it suffices if there is an intention to make chargeable profits even though none are in fact generated.

6.9 The loan to A Ltd was on commercial terms and likely to generate better results than a bank deposit. Ms Chua said 'the prospect of making a profit from [B Ltd] loan is not remote let alone illusory'.

6.10 Ms Chua argued that by prepaying a year's interest at 9% the Taxpayer stood to gain a profit being a gross 1% on the loan form the interest paid to it by A Ltd. If the P/N amount is divided by 365 the interest rate applicable to 26 March 1986 to 31 March 1986 would be US$11,064.25 ($86,301.15) versus the US$12,294 ($96,127) received from A Ltd – hence there is a real profit of US$1,230 ($9,594) for the year ending 31 March 1986.

6.11 Lord Denovan in Mangin referred to applicable rules of interpretation including the passage that 'moral precepts are not applicable to the interpretation of Revenue Statutes'.

6.12 As to section 61 it was noted that section 61A had not come into force by 31 March 1986. Therefore those cases which deal with section 61A 'dominant purpose' situations can be ignored. In D52/86 the Board of Review found that section 61 could have no application where there was specific provision for deductibility - hence if indeed an expense was deductible per se then there is no room for challenging the deductibility under section 61 on the ground that the expense had been deliberately incurred to take advantage of its deductibility for tax. This Board of Review decision rejected the principles laid down (per Lord Brightman) in Furniss v Dawson as being inapplicable in Hong Kong.

6.13 In the Challenge case Lord Templeman drew a distinction between 'tax mitigation' and 'tax avoidance'. The Taxpayer's interest expense was plainly purely a matter of 'tax mitigation' which on the basis of the Challenge decision cannot be prejudiced by a provision similar to section 61.

6.14 Onus of proof: once the taxpayer establishes that the interest expense was in fact incurred he has to discharge the onus under section 68(4) of proving the

assessment is excessive. The onus then shifts to the Commissioner to show the artificiality or fiction. Ms Chua cited the CEC Singapore decision in support.

7. SUBMISSIONS ON BEHALF OF THE COMMISSIONER

7.1 Mr D'Souza cited Lord Wilberforce in Ramsay as authority for the proposition that the Board is not compelled to isolate its review simply to the transactions between the Taxpayer, A Ltd and B Ltd. The Board is entitled to examine all the related transactions and to take view on the consequences for the whole group.

7.2 As to Ms Chua's contention that even though an expense, which is claimed as interest, does not satisfy section 16(2) it can nevertheless be deductible as an expense under section 16(1), County Shipping is unequivocal authority to the contrary. The ground of appeal in paragraph 3.1(a) above must therefore fail.

7.3 In order for a sum to qualify as 'interest' under section 16(2) the relationship between the payer and recipient must be that of debtor and creditor for money borrowed (that is the principal)(Cairns at page 577 was cited in support). No such relationship existed between the Taxpayer and the bank in Hong Kong. The money paid to the bank in Hong Kong was not received by the bank as 'interest' and the bank never lent the relevant loan to the Taxpayer.

7.4 Reference was made to Overseas Containers which was concerned with the interposition of Overseas Containers Ltd's finance company as a trading company to set off 'trading' exchange losses against group profits. Apparently neither the Commissioners nor Vinelot J nor the Court of Appeal considered in necessary to rely on Ramsay.

7.5 The only reasonable inference to be drawn from a review of the documentary evidence of all the transactions is that the Taxpayer itself had no commercial purpose. If the Taxpayer wishes to rebut that inference then it must produce evidence.

7.6 It was submitted that section 61 does not operate against tax mitigation but it does operate against tax avoidance. In the latter situation in truth the Taxpayer or his group neither suffers a loss nor makes a profit, which is precisely the situation so far as the A Ltd group was concerned.

7.7 Mr D'Souza then drew our attention to the Privy Council decision in Seramco which was concerned with a dividend stripping (tax avoidance) scheme. In that case the Commissioner of Income Tax in Jamaica invoked a legislative provision in almost the same words as our section 61. The Privy Council concluded that having regard to the circumstances in which it was made the transaction concerned was artificial.

7.8 Mr D'Souza volunteered that if the transactions could properly be disregarded under section 61 then logically the Taxpayer should not be liable to tax on the five days interest received from A Ltd.

8. CONCLUSION

This case raises a number of issues. For convenience we will deal and dispose of them in the following order.

FIRST ISSUE: SECTION 16(1)

If we conclude the claimed expense does not constitute 'interest' within the contemplation of section 16(1)(a) may it nevertheless be treated as an expense within the general deductibility provision of section 16(1)? In our opinion the following excerpt from the judgment of Fuad V-P in County Shipping is a complete answer to the contrary.

> '… because section 16(1)(a) makes it perfectly clear that where interest upon money borrowed for the purpose of producing profits in respect of which a person is chargeable to tax is sought to be deducted, it may be deducted if the provisions of one of the paragraphs of sub-section (2) are satisfied but not otherwise.'

We therefore find against the Taxpayer on this first issue.

If Ms Chua's point is that it can nevertheless be treated as an expense simpliciter we would reject that contention because the claimed expense has all along been characterized as 'interest' – it is not now open to the Taxpayer to argue otherwise.

SECOND ISSUE: SECTION 16(2)(c)

Was the claimed expense, qua interest, chargeable to tax in the hands of the recipient?

The Deputy Commissioner seemed to take the view that the bank in Hong Kong can be disregarded because B Ltd was the recipient of the P/N amount, see paragraph 2.1.2 above. We are unsure whether the Deputy Commissioner was treating delivery of the P/N amount to B Ltd as equivalent to paying interest to B Ltd: perhaps he had in mind the point made by Ms Chua at paragraph 6.3 above, 'an expense includes a sum in respect to which there is an obligation to pay' – Mr D'Souza did not address this point.

However we have this to say regarding Ms Chua's submission that we are entitled to infer that the bank was eligible to tax on the claimed expense. Firstly the very fact that the P/N amount was discounted in USA suggests a wish to avoid tax, otherwise why not quite simply discounted it in Hong Kong. Secondly we fail to see how the whole of the

claimed expense could be treated as profit in the bank's hands. Surely the only profit the bank made was the discount of US$2,600: the fact that that amount might be eligible to tax would not justify treating the whole claimed amount as interest. Anyhow we do not know if that USA branch of the bank or the bank in Hong Kong, made the US$2,600 profit. Finally we accept Mr D'Souza's argument at paragraph 7.3 above that there must be a relationship of creditor and debtor for borrowed money which did not exist between the Taxpayer and the bank in Hong Kong. We therefore find against the Taxpayer on this second issue.

If we were to dismiss the appeal solely for the foregoing reason, then the interest of $96,127 received by the Taxpayer from A Ltd (referred to at paragraph 1.15 above) would be taxed as shown at paragraph 1.18 above. If however we were to find that section 61 was properly invoked then as Mr D'Souza has indicated (refer paragraph 7.8 above) logically the interest paid by A Ltd should also be disregarded in which event the Taxpayer would not be liable to pay any tax but the claimed expense could not be set against X Ltd's own taxable profits.

THIRD ISSUE: IN THE PRODUCTION OF TAXABLE PROFITS

We therefore intend to deal with the applicability of section 61. Before doing so we will address the question of whether or not the claimed expense was incurred in 'the production of profits' that is in pursuit of taxable profits. This raises two preliminary points. (1) Are we entitled to take into account all the circumstances surrounding the transactions involved or, as Ms Chua contended, must we confine ourselves simply to those transactions to which the Taxpayer was a party? (2) Are we entitled to draw inferences as to the Taxpayer's motive for incurring the claimed expense or must our inferences be limited only to the objective purpose for which the expense was incurred?

As to question (1) we believe that the judgments in the following cases either explicity or by implication, justify the 'surrounding circumstances' approach. Cairns (at page 570) where the Commissioners were advised that the parties agreed the Commissioners 'should have regarded both to the documents and to the surrounding circumstances …': that remark was not disputed on the two subsequent appeals. In Magna Alloys Brennan J remarked at page 4548 that 'In the 51(1) [similar to section 16(1)] may be in question, there are many in which there are no contractual arrangements and many in which contractual arrangements are but part of the background in which the character of the expenditure falls for consideration.' In Swire Pacific where all the surrounding circumstances were examined both by the Board of Review and on appeal (where Leonard J referred at page 1166 to 'the essential purpose' and at page 1171 to 'the paramount purpose'): it is noteworthy that they did so even though section 61 was not in issue. Overseas Containers referring to associated companies confirms the correct approach is not to look 'merely [at] the position of the taxpayer company in isolation'.

Turning now to question (2) we consider that until the moment is reached when the examining body believes there is prima facie evidence of artificiality or fiction (section 61), motive (that is reason) is not in issue (unless of course the taxpayer chooses to adduce

evidence as to what his motives were). We answer (2) in the negative. Consequently in examining this third issue we will confine ourselves to determine the objective purpose in the light of the surrounding circumstances and disregard motive.

In this examination we take the view that we have to satisfy ourselves, on the balance of probabilities, that the objective purpose for incurring the claimed expense was a commercial one because the pursuit of taxable profits implies commerciality since ventures which are not commercial by nature are not taxed. We propose to characterize the Taxpayer as though it was wholly owned by X Ltd because X Ltd (a) held 99% of the Taxpayer and (b) was jointly liable with Y Ltd by virtue of section 11 of the Partnership Ordinance, accordingly the partnership may be disregarded for the purpose of a practical examination. We also remind ourselves that all the participants, with the exception of the bank, were controlled by A Ltd.

If we begin the exercise at the opening moves concerning the loans we find that X Ltd advanced the loan to B Ltd interest free, then in its capacity as a partner X Ltd borrowed it back at interest (which in the event was 9%). Of itself there is no commercial advantage for X Ltd in that arrangement, particularly so since, for the very reason that interest received by B Ltd would not be taxable, interest paid by X Ltd would not be deductible from X Ltd's profits. The next step at first glance appears to circumvent the section 16(2)(c) problem because B Ltd passed title to the interest of US$807,692.31 to the USA branch of the bank (in consideration of US$805,092.30) which arguably (and disregarding our decision in the second issue above) may bring the interest into charge to tax. But as X Ltd – qua partner – seemingly did not have the necessary US$807,692.31 (its 1986 accounts show only $857,747 – US$109,967.56) it borrowed US$805,092.30 from B Ltd: we do not know whether this second loan was also subject to interest or was interest free. The result thus far is that X Ltd, through the Taxpayer, had made a gift of 99% of US$805,092.30 to B Ltd. Subsequent events shed no light on the commercial reason for X Ltd's generosity. Moreover X Ltd, through the partnership, next extended its largesse to A Ltd, the due date for the first payment of interest being set on 30 September 1986 although A Ltd did not pay the Taxpayer the half year's 10% interest of US$448,717.95 ($3,500,000) it is supposed to pay, X Ltd took no action for the default. However by the second assignment again at first sight the generosity at last appears to pay off when B Ltd paid an ostensible premium of US$788,760.10 to acquire the loan. But since the assignment includes the right for B Ltd to collect interest from Y Ltd the ostensible premium should be reduced by the value of the uncollected US$448,717.95 to US$340,042.15. But the arithmetic does not end there because X Ltd – through the Taxpayer – still owed B Ltd US$805,092.30 borrowed to redeem the P/N amount, the result therefore is that X Ltd lost 99% of US$465,050.15 (the negative result after deducting the US$805,092.30 from the US$340,042.15).

It could of course be argued that the ostensible premium of US$788,760 represented partial payment of interest overdue by A Ltd to the Taxpayer which B Ltd could now collect. As Mr D'Souza did not raise the point we shall not deal with it.

Without therefore resorting to any speculation regarding the Taxpayer's motive or artificiality we fail to see any evidence of commercial purpose in the transactions. Ms Chua has pointed out that the Taxpayer did make a taxable profit of the five days interest of $96,127 (US$12,294) paid by A Ltd but that argument would only succeed if we believed that it was a real rather than a bookkeeping profit. Bearing in mind that it cost the Taxpayer $6,300,000 to achieve the supposed profit of $96,127 the return would be a mere 1.525% which just might have made some commercial sense if the Taxpayer were in fact to collect the far greater interest due by A Ltd in September 1986. As it did not do so we consider Ms Chua's argument to be specious.

Since, viewed objectively, we can find no commercial justification for incurring the claimed expense and no alternative explanation has been offered we reject the Taxpayer's ground of appeal on the third issue and hold that the claimed expense was not incurred in the pursuit of taxable profits. Under this third issue, we need not draw any inference as to what the ulterior purpose was nor resort to section 61, except in relation to the question of whether the $96,127 should be taxed.

Before dealing with section 61 however the onus of proof question must be dealt with.

FOURTH ISSUE: ONUS OF PROOF

Ms Chua points to the Singapore CEC case as justification for saying that the onus is upon the Commissioner to prove the transaction or transactions in question are 'a sham'. The Singapore judgment however indicates that CEC had given evidence and made out a prima facie case 'showing among other things that everything was above board and genuine' (page 554) and later 'The burden of proof throughout until the end of the Comptroller's case, however, rests on the taxpayer to show that the tax is excessive' (page 555). These remarks do not support Ms Chua's submission. In Kum Hing Land this topic was ventilated and the court held that the 'company has to satisfy the Board that section 61 … has been wrongly applied'. That decision is of course binding on us and we therefore hold that the onus is upon the Taxpayer to satisfy us that the Deputy Commissioner was wrong; in that respect no new material evidence was adduced before us. We have however to deal with the arguments of the Taxpayer's representative.

FIFTH ISSUE: SECTION 61

Although we have examined closely the various authorities referred to we do not propose to embark on an analysis of the decisions. We feel that the facts and statutory law in the Seramco case bear the closest analogy to the case before us and adopt the remarks of the Judicial Committee as our guide. The transactions there were 'unrealistic from a business point of view (Lord Diplock page 294) and the fact that the share agreement provides for dividend stripping is not of itself sufficient to bring it within the sub-section of section 61 … It is only when the method used for dividend stripping involves a transaction which can be properly described as "artificial" or "fictitious" that it comes within the ambit

of section 10(1)' (our section 61). Whether it can properly be so described depends upon the terms of the particular transaction that is impugned and the circumstances in which it was made and carried out (ibid page 297) and later a fictitious transaction is one which those who are ostensibly the parties to it never intended it should be carried out. 'Artificial' as descriptive of a transaction is a word of wider import. Their Lordships will accordingly limit themselves to an examination of the shares agreement and the circumstances in which it was made and carried out, in order to see whether that particular transaction is properly described as 'artificial' within the ordinary meaning of that word (ibid page 298).

Before proceeding we ought perhaps to deal with D52/86 where the taxpayer took advantage of the fact that interest paid by the taxpayer to its shareholders on a loan made available in New York was then deductible from the taxpayer's profits notwithstanding that the interest was not at that time chargeable to tax in the hands of the shareholders because section 16(2) in its present form (which closes the loophole) did not come into force until 1 April 1984. The Board in rejecting artificiality concluded after evidence adduced by the taxpayer that the 'agreements were … intended to be carried out to the full …'. It is also clear that there was a strong degree of commerciality, for instance the taxpayer made profits through employing one of its shareholders and after he retired to Australia the property concerned was let out to third parties. We accept that the summary at paragraph 6.12 above of Ms Chua's interpretation of the ratio decidendi of the decision in D52/86 is correct. However that summary begs the question whether the expense was incurred in the pursuit of profits chargeable to profits tax. In the case before us we have concluded that the claimed expense was not so incurred and the rationale cannot therefore come into play.

Turning now to the matter of artificiality we start by saying that we adopt with approval the comments of the Deputy Commissioner paraphrased at paragraph 2.2 above, subject to our comments in the second issue regarding treating B Ltd as the recipient of the interest. We would next say that the following are indicative that the A Ltd group participants did not feel that they had to treat the terms of the various agreements seriously.

(1) Though B Ltd apparently served no written notice on the Taxpayer pursuant to clause 8(4) of the B/Taxpayer agreement the Taxpayer nevertheless issued the P/N amount.

(2) The P/N amount was issued before the loan was received.

(3) Most of the terms of the loan agreements seem to us to have been based upon arm's length precedents and to have no relevance in the circumstances. For instance there are lengthy preconditions including evidence of authority to borrow and previous accounts etc and there are ponderous default provisions most of which have no place in intra-group dealings where there are no outsiders. They appear to us be included for theatrical effect.

(4) The purpose clauses in the Taxpayer/A and A/Y agreements do not reflect the true purposes.

(5) Some of the important provisions are difficult to understand.

(6) A Ltd paid interest to the Taxpayer before A Ltd received the loan.

(7) The Taxpayer failed to invoke the default provisions despite A Ltd's failure to pay interest on 30 September 1986.

These suggest that there was no serious intention to carry out the terms of the agreements 'to the full'.

We also feel that the following aspects also weigh against the Taxpayer's submissions. We were not enlightened as to whether B Ltd collected interest (whether for 30 September 1986 or 31 March 1987) from Y Ltd after the second assignment. If such interest was collected Y Ltd could not of course deduct it from its taxable profits because B Ltd is not a taxpayer, with the result that even if the claimed expense were to be allowed as deductible from the Taxpayer's profits an even greater figure (10% not 9%) would not be deductible from B Ltd's profits: therefore the A Ltd group would be worse off. The Taxpayer had no dealings with third parties, its activities being confined to the A Ltd group. If X Ltd had really wished the Taxpayer to enter into profitable ventures why did it saddle the partnership with interest when X Ltd could so easily have lent the necessary money interest free directly to the Taxpayer?

When the above remarks are taken in conjunction with the Deputy Commissioner's comments the only finding we can possibly make is that the loan and interest transactions were artificial.

Having accepted that there was artificiality we now turn to the matter of motive behind the transactions.

SIXTH ISSUE: MOTIVE

There being no direct evidence, motive in this case is merely an inference to be drawn from our earlier findings and is not essential to this decision. Nonetheless we include it for the sake of completeness. As we have already mentioned we can see no prospect for a potential taxable profit and the Taxpayer's supposed capital gain is a phantom. The only change for the group is that title to property is transferred from X Ltd to Y Ltd. Is this factor sufficient to introduce some element of reality? In other words is this transfer (which we assume involved no stamp duty) the true intention and the fact that the loan was circuitously routed was a legitimate exercise of the principle laid down in the Duke of Westminster case? We think not because even if one were to assume that the transfer was at the core of the A Ltd group's intentions, the interest itself was an artificial ingredient since the interest element achieved nothing for the group. The transfer of title to the property could have been

achieved by means which did not involve resort to artificial methods: the most obvious would be for X Ltd to allow Y Ltd credit for the whole of the purchase price, not merely the $2,335,836 referred to at paragraph 1.13.5 above.

We therefore hold that the sole motive for the loan and interest was an attempt to achieve by artificial non-commercial means a tax advantage. To adopt the words of Norris J in Cairns (pages 578 and 580) the claimed expense 'was a payment made in discharge of a purely artificial liability which was created in order to achieve a tax advantage'.

SEVENTH ISSUE: CHOICE OF GROUNDS FOR DISMISSING APPEAL

In the result we have found against the Taxpayer on three fundamental grounds, viz (a) section 16(2)(c) was not satisfied, (b) the claimed loss was not incurred in the production of profits (section 16(1)) and (c) artificiality of all the loan and interest transactions. However (a) and (b) do not impugn the Taxpayer's receipt of the A Ltd interest whereas (c) would logically result in that interest being disregarded. Having reached the conclusion at (c) it would be inconsistent to uphold the 1985/86 assessment for us to do so would imply that the transaction giving rise to that interest was itself genuine. We therefore direct that the 1985/86 assessment be annulled and that the claimed expenses be disallowed in full. Whilst we are not concerned with any assessment made or to be made upon X Ltd or Y Ltd in relation to the claimed expense we consider each of them is a 'person concerned' within the meaning of section 61 and believe the consequence of the foregoing direction is that if either of them claim a pro tanto share of the Taxpayer's losses such claim should be disallowed. If we are wrong in this belief either party may refer the matter back to us in order to amend the foregoing direction to achieve that result.

We are indebted to the two representatives for the professional manner in which they conducted this appeal.