INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D70/90

Profits tax – claimed expenses – whether income or capital – whether application of taxable profits.

Panel: Robert Wei QC (chairman), Frank Pong Fai and Andrew Wang Wei Hung.

Date of hearing: 30 November 1990.
Date of decision: 18 February 1991.

The taxpayer claimed that certain repayments of unsecured loan capital or transfers of shareholder's funds or reserves should be deducted in computing the assessable profits of the business. The assessor disallowed the payments because they were of a capital nature. The taxpayer appealed to the Board of Review.

Held:

The payments were of a capital nature and therefore not deductible. Alternatively the payments were the application of profits and not expenses incurred in earning profits.

Appeal dismissed.

Cases referred to:

CIR v Lo & Lo (CA) [1982] HKLR 503
CIR v Lo & Lo (PC) 2 HKTC 34
Mersey Docks and Harbour Board v Lucas 2 TC 25

Chiu Kwok Kit for the Commissioner of Inland Revenue.
Taxpayer represented by a Mr Y.

Decision:

This is an appeal by the Taxpayer trading as X Company against the determination of the Deputy Commissioner of Inland Revenue dated 12 September 1989 confirming the profits tax assessments raised on her for the years of assessment 1986/87 and 1987/88 on the grounds that certain sums claimed to be repayments of unsecured loan

capital or alternatively transfers to shareholders funds/reserves should be deducted in computing the assessable profits.

2. The Taxpayer did not appear at the hearing, but was represented by a Mr Y. No witness was called. The documents produced by Mr Chiu, the Commissioner's representative, were not in dispute. The primary facts, so far as material to this decision, are as follows:

(a) The Taxpayer commenced business in February 1985 as a sole proprietress and carried on the business until it ceased in February 1989. In her profits tax returns, the business was described as 'trading and design service'.

(b) Annual accounts were filed together with profits tax returns for the three years of assessment 1985/86, 1986/87 and 1987/88. None of the balance sheets contains any item for capital as such. Instead there is an item 'Loans (unsecured) and obligations amounting to $85,108.16 in the balance sheet as at the end of the year 1985/86, and $12,000 in the balance sheet as at the end of the year 1986/87'. On the other hand, the profit and loss account for 1986/87 shows a deduction of $24,422.47 described as 'Repayments of unsecured loan capital' while that for 1987/88 shows a deduction of $68,000 described as 'Repayment of capital of unsecured loans'.

(c) The profits tax return for 1985/86 disclosed an adjusted loss of $28,329 which was accepted by the assessor. As for 1986/87 and 1987/88, the profits were assessed in the sums of $56,231 and $122,627 respectively.

(d) Subsequently in her correspondence with the Commissioner of Inland Revenue, the Taxpayer revised her profit and loss accounts for 1986/87 and 1987/88 by describing the deduction of $24,422.47 and that of $68,000 as sums 'transferred to shareholders funds/reserves'.

(e) The Taxpayer explained the revision in her letter to the Commissioner of Inland Revenue dated 29 June 1989 in the following terms:

> ' <u>Repayment of loan</u>
>
> In answer to this aspect it is obvious I received the funds (loans), that is the principal from the shareholders, otherwise I could not have commenced my business. I have not treated the transfer of funds (loans) as expenses, but as a reserve fund (loan) to meet liabilities incurred in setting up my business. The funds raised therefore are or equate to a share value or shareholders fund, which was required as a reserve in order to commence my business.'

(f) In her notice of appeal, the Taxpayer stated that the loans were not repaid and that the capital was not withdrawn but held in reserve. The sums reserved, she stated, were equal to the original 'principal' put into the business to enable her to commence; without this original 'principal' there could have been no production of profits.

3. The assessor disallowed the two deductions; the Taxpayer contends that he was wrong.

4. The authority for making deductions is section 16(1) of the Inland Revenue Ordinance, which was paraphrased by Leonard V-P in CIR v Lo & Lo (CA) [1982] HKLR 503 at 509 as follows:

> 'In order to ascertain the taxable profits you shall deduct from the total of receipts and sums deemed to be receipts all outgoings and expenses to the extent to which they are incurred in the production of such profits.'

In the same case Lord Brightman observed in the Privy Council (2 HKTC 34 at 71):

> 'Sections 16 and 17 provide exhaustively for deductions in the sense that permitted deductions are confined to outgoings and expenses incurred in the production of profits in respect of which tax is chargeable; that such permitted deductions expressly include those specified in (a) to (h) of section 16(1), and expressly exclude those in section 17.'

Furthermore, in the Court of Appeal it was held that an expense was incurred because it was assumed; that the fact that the liability was contingent did not prevent the expense from being 'incurred' (per Leonard V-P at 509); that the word 'incurred' 'includes the acceptance of a liability as well as the meeting of that liability as and when it matures' (per Cons, JA at 511). Section 17(1)(c) expressly excludes from deduction loss or withdrawal of capital and expenditure of a capital nature.

4.1 Withdrawal of capital and expenditure of a capital nature

In so far as the two claimed deductions are 'repayment of capital', we think they fall within the meaning of 'withdrawal of capital' and therefore are not deductible. In so far as they are sums 'transferred to shareholders funds/reserves', they are expenditure (not including actual payment) of a capital nature and therefore also not deductible.

4.2 Application of profits

Alternatively, we take the view that repayment of capital and transfer to shareholders funds/reserves are merely instances of applying the profits after they have been produced rather than outgoings or expenses incurred in

producing them. We find support for this view in Mersey Docks and Harbour Board v Lucas 2 TC 25, cited by Mr Chiu. In that case a harbour board was empowered by Act of Parliament to levy dock dues, etc, to be applied in maintaining the concern, and in paying interest on moneys borrowed; any surplus income remaining after meeting these charges was directed to be applied in forming a sinking fund to extinguish the debt incurred in the construction of the docks. It was held that the surplus was profit assessable to income tax. Lord Selborne LC said at page 28:

'The tax is to be charged upon the profits … and it is to be charged "on the amount of the produce or value thereof". What is "thereof"? Of the concern which the corporation carries on. If we had nothing more than that, I should have thought that we were to consider not the application of the moneys which the Mersey Board received when they had received them, but the "profits of the concern" in the sense of the "produce or value" which could properly be described as "profits of the concern", and that surely could be all the net proceeds of the concern after deducting the necessary outgoings without which those proceeds could not be earned or received. But … the Act does not stop there, it goes on and says that this charge is to apply "before paying, rendering, or distributing the produce or the value either between the different persons or members of the corporation, company, or society engaged in the concern" … "or to any creditor or other person whatever having a claim on or out of the said profits" … To my mind it is exactly the same thing as if there had been a declaration that, after paying the current expenses and all other necessary outgoings, without which nothing could be earned, the clear surplus profits and gains of the undertaking should be applied in a certain manner, that is the substance of it. The mode of the application makes no difference whatever to the question of what is "profit" and what is "gain".'

Lord Blackburn said at page 33:

'There is nothing in the nature of things, there is nothing in the words of the Act, to say that when an income has been actually earned, when an actual profit upon which the tax is put has been earned and received by any person or corporation, Her Majesty's right to be paid the tax out of it in the least degree depends upon what they are to do with it afterwards, unless there is an express enactment, which I think there is in some cases, that they are to apply it to charities or other purposes. It the amount thus received is to be applied at their pleasure, they must pay the tax. If it is to be paid over to shareholders or to creditors, or to anybody else, the Queen is still to have her tax.'

The words underlined by us in the above cited passages show that instances of application of profits, such as payments to creditors are not deductible whether there is express legislation to exclude them or not. The United Kingdom law and the Hong Kong law differ in scope in that the UK deductions are confined to expenditure necessary to earn the receipts, while in

Hong Kong they are expenditure 'incurred' in the production of profits, which is considered to be wider in scope (Professor Willoughby's Hong Kong Revenue Law, vol 2, 2-241). However, this difference, notwithstanding the distinction drawn in Mersey Docks and Harbour Board v Lucas between ascertainment of profits and application of ascertained profits, is in our view equally applicable in Hong Kong.

5. For all these reasons, we are of the view that the two claimed deductions were rightly disallowed.

6. With regard to the adjusted loss of $28,329 for 1985/86, the Deputy Commissioner's determination is in the following terms:

> 'The Taxpayer elected to be personally assessed under part VII of the Inland Revenue Ordinance for the year of assessment 1985/86 and her loss of $28,329 should be deducted from her total income in her personal assessment for the same year. As a result, no loss was available in accordance with section 19C(1) of the Inland Revenue Ordinance for set off against the amount of her assessable profits from the business for the year of assessment 1986/87.'

In her notice of appeal the Taxpayer alleged that she was forced by intimidation to elect to be personally assessed and was 'bombarded' with forms requesting her to opt for personal assessment. These are serious allegations and call for the clearest evidence before they can be established. Since the Taxpayer chose not to give any evidence, the allegations fail and the election must be taken to be valid and effective. Mr Chiu while categorically denying the allegations, stated that the Taxpayer was welcome to withdraw her personal assessment if she so wished. However, Mr Y was not ready to take up the offer; he had to seek advice. Therefore, so far as this appeal is concerned, the personal assessment is in force, and there is nothing we can fault in the words of the Deputy Commissioner quoted at the beginning of this paragraph.

7. It follows that this appeal is dismissed and that the profits tax assessments for the years of assessment 1986/87 and 1987/88 are hereby confirmed.