Case No. D71/97

Profits tax – source of profit – rebates/discounts in respect of trades executed by overseas brokers on foreign stock exchange.

Profits tax – section 16 – whether interest on subordinated loan redeposited offshore is deductible expense.

Panel: Audrey Eu Yuet Mee SC (chairman), Robin M Bridge and Dianthus Tong Lau Mui Sum.

Date of hearing: 6 October 1997.
Date of decision: 30 October 1997.

Appeal partially allowed.

Cases referred to:

CIR v Hang Seng Bank Ltd [1990] 1 HKRC 90-044
CIR v HK-TVB International Ltd [1992] 1 HKRC 90-064
Wardley Investment Services (Hong Kong) Ltd v CIR [1993] 1 HKRC 90-068
Commissioner of Income Tax, Bombay Presidency and Aden v Chunilal B Mehta of Bombay [1938] LR 65 IA 332

So Chau Chuen for the Commissioner of Inland Revenue.
David Southwood of Messrs Edsaco Horwath Tax for the taxpayer.

Decision:

APPEAL

1. The Taxpayer appeals against the determination of the Commissioner dated 25 November 1996 in respect of the additional profits tax assessments for the years ending 31 December 1992 and 31 December 1993. The disputes relate to two issues:

(a) whether the rebates and discounts given by overseas brokers are taxable profits arising in or derived from Hong Kong under section 14 of the Inland Revenue Ordinance ('the IRO');

(b) whether interest paid on a loan from the Taxpayer's parent company is deductible outgoing and expense under section 16 of the IRO.

2. The facts, the law and the considerations relating to the two issues are self contained and it is convenient if we deal with each issue separately.

THE BROKER'S REBATE OR DISCOUNT

3. The question is whether the Taxpayer's income in the two relevant years ended 31 December 1992 and 1993 from broker's rebates/discounts in respect of trades executed by overseas brokers on foreign stock exchanges are non taxable offshore profits as contended by the Taxpayer.

THE FACTS

4. The relevant facts are not in dispute and we set them out as follows.

5. The Taxpayer is a company incorporated in Hong Kong on 23 January 1981. For the two years under review, its only office was in Hong Kong; it did not have any overseas branch office or establishment. It did not have any overseas employee.

6. As stated in the directors' reports for the relevant years, the Taxpayer's business was the 'provision of investment advisory and related services.' It acted as an investment manager for its clients or customers or specific funds. For purpose of brevity, we shall henceforth collectively refer to them as the Taxpayer's 'customers'.

7. The Taxpayer entered into management agreements with its customers. We are supplied with an agreement with one particular customer dated 1 June 1985. It is accepted by both parties as a sample agreement for all others. The management agreement states that the Taxpayer will provide investment and advisory services to the customer as to the investment of the customer's assets in certain venture capital investments within Country C. The Taxpayer has the discretion to invest moneys of the customer in accordance with the investment objectives and overall guidelines issued by the board of directors of the Taxpayer and with the Prospectus and any amendments thereto. For the services rendered, the Taxpayer receives a management fee on specific portions of the total net assets invested. There is also a performance fee calculated on a percentage of the net profits achieved. There is no mention of any other fees or disbursements which is payable by the customer.

8. According to Mr Southwood for the Taxpayer, and this is not challenged by the Revenue, the Taxpayer was at all times registered with the Securities and Futures Commission as an investment adviser and securities dealer. Its funds were authorized with the regulatory authorities in Country A and Country B. It did not need prior approval from its customers to undertake transactions and had the discretion both as to the investments to be sold or purchased and also discretion as to the brokers to be used to effect these trades.

9. In the course of managing the funds of its customers, the Taxpayer would give instructions for the acquisition or disposal of securities in Hong Kong and elsewhere. Where the securities were traded on a stock exchange outside Hong Kong, the acquisition or

disposal had to be effected through brokers who were able to trade on that exchange. Thus these trades had to be executed through overseas brokers who were authorized by the particular overseas exchange and during the opening hours of that exchange. Neither the customer nor the Taxpayer would be able to effect these trades except through these overseas brokers.

10. Many of these overseas brokers had offices in Hong Kong. In those cases, the trades were placed through the telephone with the local Hong Kong offices of the brokers concerned for onward transmission to the relevant offshore offices. The overseas office then executed the orders on the overseas exchange. In case of a broker who did not have an office in Hong Kong, the order was placed directly with the broker in the foreign country. Confirmation would be notified to the Taxpayer either by the overseas office or by the Hong Kong office. A telex or fax confirmation would follow from the broker giving details including the brokerage. The fax would be issued by the overseas office if there was no local office. Where there was a local office, the fax confirmation would usually, but not always, come from the local office.

11. After checking the accuracy of the broker's confirmation, the Taxpayer would issue a trade confirmation to its customer. The amount of the brokerage was shown on a gross basis, that is, the usual or the maximum rate permitted by the relevant stock exchange.

12. The Taxpayer had entered into various verbal agreements with these overseas brokers for a rebate or a discount in respect of these brokerage fees. A rebate is described as a 'kick-back' which the overseas brokers later returned to the Taxpayer after the Taxpayer had initially paid a gross brokerage whereas a discount means that the Taxpayer only pays the overseas broker a discounted brokerage fee. With the exception of the Country C stock, all brokerage were completed on the discounted basis agreed with the relevant broker. In the case of Country C stock, the brokerage was shown as gross. The rebate was calculated on a monthly basis and paid to the Taxpayer every month.

13. The sample management agreement referred to above made no mention of brokerage, rebates or discounts. It is agreed by the Taxpayer and the Revenue that it was the usual trade practice for the customer in these cases to pay the brokerage in gross and for the fund manager to keep the rebates or discounts given by the overseas brokers. The difference between the two gave rise to a profit to the Taxpayer.

14. The Taxpayer produced a number of appendices. One shows that in 1992, overseas rebates or discounts were received from brokers in respect of securities traded on the stock exchanges in Country D, Country C, Country E, Country F, Country G, Country H, Country I, Country J, Country K and Country L. The rebates and discounts are shown in the original currency but it is not clear whether they were paid in that currency. The majority of these brokers had offices in Hong Kong. Another appendix shows that most of the agreements with the brokers were negotiated in Hong Kong. In respect of those agreements negotiated offshore, we are told that they were negotiated by members of the Taxpayer's staff during visits to the overseas brokers several years before the years under review. Although the agreements were verbal, some were evidenced by 'dealing

procedures' between the Taxpayer and the relevant broker. Samples of these were provided to us. We are told that these were not really the agreements but merely documents for administrative purposes for use by the back office staff of both parties. They show the rate of the rebates or discounts agreed between the Taxpayer and the broker.

15. For the year ended 31 December 1992, the Taxpayer's income included brokerage rebates and discounts of $7,048,116. $1,680,405 of that were in respect of trades done in Hong Kong and these were offered for profits tax. $5,367,711 were in respect of trades executed by overseas brokers on foreign stock exchanges and were treated by the Taxpayer as non taxable income. The notation for this latter sum in the accounts was as follows: 'The offshore brokers' rebates, amounting to $5,367,711 constitute passive income generated by the operations of selling and buying of securities through exchanges wholly undertaken outside Hong Kong.'

16. For the year ended 31 December 1993, the Taxpayer's income included brokerage rebates and discounts of $13,025,498. $1,182,921 of that were offered for profits tax being rebates or discounts in respect of trades done in Hong Kong. The balance of $11,842,577 were given the same notation and treated by the Taxpayer as non taxable income.

17. The Commissioner found that the sums of $5,367,711 and $11,842,577 were taxable as profit arising in or derived from Hong Kong. The Taxpayer appealed.

THE LAW RELATING TO SOURCE OF PROFIT

18. The principles relating to this area of the law is well settled by recent Privy Council decisions but the application of these principles to the facts of each case is not always easy. We will first set out the well known principles.

19. Section 14 of the IRO contains three conditions that need to be satisfied before there is a charge to profits tax:

(a) the taxpayer must carry on a trade, profession or business in Hong Kong;

(b) the profits to be charged must be from such trade, profession or business;

(c) the profits must be profits arising in or derived from Hong Kong.

There is no issue on the first two requirements. Only the third requirement, the source of these brokers' rebates/discounts, is in dispute.

20. The parties are agreed on the relevant test as stated by Lord Bridge in Commissioner of Inland Revenue v Hang Seng Bank Limited [1990] 1 HKRC 90-044 at page 100; 422; 322; 488:

> *'But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question.'*

The parties also cited Lord Jauncey in Commissioner of Inland Revenue v HK-TVB International Ltd [1992] 1 HKRC 90-064 where at 100,540;407;528 he reiterated and expanded the guiding principles in the earlier cases as follows:

> *'I think the question is, where do the operations take place from which the profits in substance arise?'*
>
> *'one looks to see what the taxpayer has done to earn the profit in question and where he has done it.'*

21. The Revenue relied on Wardley Investment Services (Hong Kong) Limited v Commissioner of Inland Revenue [1993] 1 HKRC 90-068. The Taxpayer tried to distinguish it. The facts in that case were very similar. As stated in the headnote, the taxpayer was an investment adviser engaged in the management of customers' investment portfolio under management contracts. The taxpayer arranged the buying, selling and exchange of securities on behalf of its customers in Hong Kong and elsewhere through dealers and brokers. The entire operation, organisation and facilities of the taxpayer were situated in Hong Kong. All decisions and instructions concerning the business, including the management of overseas back and securities accounts, were made and given in Hong Kong. The taxpayer made use of overseas brokers who were also instructed from Hong Kong. The one difference relied on by the Taxpayer as the distinguishing feature was that in the management agreements with the customers, the taxpayer was entitled to 'additional remuneration as manager'. This was the rebates and share commissions from local and overseas stockbrokers which it employed to perform the transactions. The majority of the Court of Appeal reversed the decision of the Board and found that the additional remuneration was taxable.

22. Giving the lead judgment, Fuad VP said:

> *'When addressing the question the Board had formulated for itself: "where did the operations take place from which the profits in substance arise", in my respectful judgment, the Board did not appear to appreciate that it is the operations of the taxpayer which are the relevant consideration … the Board had looked more at what the overseas brokers had done to earn their profits. Of course, there would have been no "additional remuneration" ultimately credited to the taxpayer if the brokers had not executed the relevant transactions, and these took place abroad, but this does not tell us what the taxpayer did (and where) to earn its profit.'*

He emphasized the fact that the taxpayer was carrying out its contractual duties to its client and performing services under the management agreement in Hong Kong and in return receiving the management fee as well as the 'additional remuneration as manager' to which it was entitled under the management agreement. He found that the taxpayer did nothing abroad to earn the profit sought to be taxed. He said the taxpayer was acting precisely in the same manner, and in the same place, to earn its profit whether it was giving instructions to a broker in Hong Kong or overseas.

23. Penlington JA agreed with Fuad VP. In addition, he said that the profit only arose when the amount of the rebate was debited to the customer in Hong Kong and credited to the taxpayer. Thus the operations from which the profits arose was the debiting of the customer with the full rate of the commission and the retention, pursuant to the agreement, of the difference between that and the discounted rate. Such operation took place in Hong Kong.

24. Cons VP dissented. When asked what the taxpayer did to earn the profits in question, he said 'to put business in the way of an overseas broker'. He came to the conclusion instructions to the brokers were valueless until received and the transaction carried out. The overseas broker had the money in his hands and it had never even notionally reached the customer. He did not think that the clause in the management agreement meant that the rebate emanated from the customer. For those reasons, he regarded the rebate as overseas income.

25. Another case referred to is Commissioner of Income Tax, Bombay Presidency and Aden v Chunilal B Mehta of Bombay [1938] LR 65 IA 332. The respondent was a commodity broker carrying on business in Bombay. It traded in commodity futures on exchanges outside Bombay and it gave instructions to brokers operating on those foreign exchanges. The Privy Council found that the profits from such trading were not profits accruing or arising in British India even though the contracts made abroad depended upon instructions emanating from Bombay and upon the exercise in Bombay of knowledge, skill and judgement on the part of the taxpayer.

THE TAXPAYER'S CASE

26. Mr Southwood for the Taxpayer distinguished the **Wardley Investment** case on the ground that here the management agreement was silent on the brokerage rebates. There was no question of additional remuneration as part of a return for services rendered by the Taxpayer. He said that the rebates/discounts were not money of the customer and, were outside the contractual relationship between the fund manager and the customer.

27. Mr Southwood also argued that the majority judgment was incorrect. He urged us to follow the decision of the Board and the minority decision of Cons VP. He referred us to the findings of the Board that the operations were the activities of the overseas agents buying and selling investments in their own overseas market places. He said that the brokers were agents of the Taxpayer and what the agents did were really the acts of the

principal. He relied on the Board's findings that the profits of overseas broker were not taxable as Hong Kong sourced income and the overseas broker was merely sharing his profits with the Taxpayer. He criticized Fuad VP for overlooking or not dealing with the argument by Mr Kotewall for the taxpayer in that case that the overseas broker was in fact the agent and it was thus not correct for Fuad VP to say that the taxpayer had done nothing abroad. He said the learned Vice President concentrated on the activities of Wardley in Hong Kong and misapplied the decision in the **Hang Seng Bank** case. He emphasized that without the execution of the trades by the overseas brokers in the overseas stock exchange, there would not be any rebate/discount and such operations were clearly offshore. He relied on the **Mehta** case to show that even if the instructions emanated from Hong Kong and the decisions were based on the skill and management in Hong Kong, the profits still arose from the trades executed overseas.

28. It was suggested in the earlier correspondence between the tax representative and the Revenue that the rebates/discounts were not taxable because they were negotiated and arose from verbal agreements made outside Hong Kong. This argument was not pursued by Mr Southwood before us and it would appear from the Appendix put forward that only a minority of the verbal agreements were made abroad.

THE REVENUE'S CASE

29. Mr So for the Revenue very carefully took us through an analysis of the three judgments in **Wardley Investment**. He said that the facts are very similar and there was no reason why the majority decision was not applicable here.

30. As to the distinguishing feature pointed out by Mr Southwood. Mr So said it was immaterial. He said that even though there was no express term in the sample management agreement which permitted the Taxpayer to retain the brokers' rebates/discount, there was an implied term by reason of the trade practice for the Taxpayer to be able to do just that. He referred us to the two passages in **Wardley Investment** in support of this contention. Cons VP said at page 100, 603:

> *'It is true that, but for the clause in the management agreement, the taxpayer could not keep that money for himself.'*

Penlington JA said later on in the same page:

> *'If the overseas broker charged its full commission but sent part of it to the taxpayer in Hong Kong, the taxpayer could not retain it but would be obliged, as the customer's agent, to account for it. It is only the terms of the agreement which enable the taxpayer, in Hong Kong, to credit the payment to itself, not the customer.'*

Mr So said that since the management agreement was silent as to the brokerage, the Taxpayer would, but for the trade practice, have to account for it to the customer. Thus he

said Mr Southwood was wrong to say that the rebates/discounts were outside the management agreement.

31. Mr So did not deal with Mr Southwood's argument that the overseas brokers were the agents of the Taxpayer. But he said that the overseas broker and the Taxpayer had split duties. The gross brokerage payable by the customer was fixed. The overseas broker and the Taxpayer was each entitled to a share of this brokerage based on their respective operations. The transactions were done by two parties, the overseas broker on the one hand and the Taxpayer on the other. Those two parties between themselves got a share of the commission based on a split agreed to in a commercial agreement between them. From the overseas broker's point of view, its split was in respect of its work, that is executing the trade overseas. From the Taxpayer's point of view, its split was for referring the business to the overseas broker. Such referral was done in Hong Kong. Mr So referred to Cons VP's dissenting judgment where he said the operations of the taxpayer was to put business in the way of an overseas broker. Mr So then asks *how* the Taxpayer did that and then *where* he did that. The answer, he said, was that the Taxpayer referred business to the overseas broker by making telephone calls and these calls were made in Hong Kong. Thus he said Fuad VP was absolutely correct when he found that the taxpayer never did anything abroad, what the taxpayer did in that case was the same as the Taxpayer here. It made telephone calls from Hong Kong. It did exactly the same things or carried out exactly the same operations whether the trade was to be executed on an overseas or a local exchange. He reminded us that we have to look at the Taxpayer's operations and these took place in Hong Kong. As between the broker and the Taxpayer, the referral was complete once the instruction was given. That was done in Hong Kong. The operations of receiving the referral and executing the order, done abroad, were not the operations of the Taxpayer.

32. He distinguished the **Mehta** case. He said it was a case on trading profits, that is profits derived from buying and selling shares and reselling them at a higher price. He said the nature of the transactions in this case was different. This was a case of service income and therefore on all fours with **Wardley Investment** rather than **Mehta**.

REASONS FOR DECISION

33. We have set out the cases and the arguments at some length so it is not necessary to repeat all of that in our reasons. We bear in mind the test and the approach laid down in the cases. We ask ourselves what the operations of the Taxpayer were and where they took place. Before that we ask ourselves what operations in substance gave rise to the profit. We must look at the totality of the facts. Mr Southwood said that without the trade being executed overseas there would be no profit. That seems to us to be looking only at part of the facts. It is true that the income came from rebates/discounts received from the overseas brokers but that alone does not give rise to a profit.

34. We need only test it in such a way. If the Taxpayer was investing or trading on its own behalf and the brokers agreed to give the Taxpayer a discount or a rebate, this meant that the Taxpayer's actual costs or expenses was the net brokerage payable. There would be no question of any profit.

35. A profit only arose in the present case because the Taxpayer was acting as the investment manager for the customer. In so doing, it was acting as the agent for the customer. It charged the customer the gross brokerage when the actual brokerage payable was the discounted sum or the reduced sum after the rebate. It is the difference between the gross and the reduced/discounted brokerage which gave rise to the profit. It is the totality of these facts which we must look at.

36. We have reservations as to Mr Southwood's argument that the overseas broker is the agent of the Taxpayer. In a way, he is correct, but then the Taxpayer is also the agent of the customer, thus one would have to end up saying that the overseas broker was the sub-agent of the customer. In the end, we are satisfied that, for profits tax purposes, the business/operations of the overseas broker should be viewed separately from the business/operations of the Taxpayer. The Taxpayer got a share of the gross brokerage for having referred business to the overseas broker and such referral was done in Hong Kong by the placing of instructions through the telephone and in the ordinary course of the Taxpayer's business operations in Hong Kong. The overseas broker got its share of the gross brokerage for its work overseas. The separate operations of the two parties gave rise to their separate profits and it would not be correct to say that the Taxpayer got a share of the broker's profits or that the broker's operations were the operations of the Taxpayer.

37. We are satisfied that the majority decision of **Wardley Investment** is applicable to our case. The Taxpayer was the agent of its customers. It charged the customer the gross brokerage as a disbursement when the actual brokerage payable was less. Thus, it would have to account to its principal, the customer, for the difference. This is the legal position and was so stated in the two passages in Cons VP's judgment and Penlington JA's judgment set out above. The trade practice did not change the law. It merely implied consent on the part of the customer to the Taxpayer's retention of the difference without having to account for it. Thus there was no difference whether the fund manager was entitled to keep the difference by means of an express clause in the management agreement as in **Wardley Investment** or by means of an implied term, implied by trade custom as in this case.

38. We are indebted to Mr Southwood who provided to us two additional documents on our request. The Securities and Futures Commission conducted a consultation and in December 1994 published the consultation conclusions on cash commission rebates and 'soft dollar' benefits received by portfolio managers from brokers. Based on the consultation conclusions, the Securities and Futures Commission published in March 1996 a code of conduct for persons registered with the Commission. This covered the Taxpayer as a person so registered but it was not in operation at the material time we are concerned with. We note that clause 13.2 of the Code provides that a registered person who acts for a client in the exercise of investment discretion may receive and retain cash or money rebates in relation to client transactions only if:

(a) the client has consented in writing to such retention of rebates;

(b) the brokerage rates are not in excess of customary full service brokerage rates; and

(c) disclosure of such rebates and their approximate value is made to the client twice a year.

This is consistent with the legal position that a fund manager can only keep the rebates/discount with the consent of the customer. In **Wardley Investment**, the consent was expressed in the management agreement. In the case before us, the consent was implied from trade practice. Since the coming into effect of the code, such consent would have to be made in writing.

39. In the circumstances, we do not see any distinguishing feature between **Wardley Investment** and the case before us. The nature of the operations of the taxpayers in the two cases are similar. Despite what Mr Southwood has urged upon us, we are clearly bound by the majority decision. It follows that the rebates/discount in dispute are taxable as profits arising in or derived from Hong Kong.

THE LOAN INTEREST

40. We now turn to the second issue. Again the facts are not in issue and we set them out as follows.

THE FACTS

41. The Taxpayer is the subsidiary of Bank M. By an agreement dated 21 December 1990, Bank M made a subordinated loan of in currency N to the Taxpayer. Article 4 of the subordinated loan agreement stated that the purpose of the loan was to enable the Taxpayer to satisfy the requirements of section 65B of the Securities Ordinance. Section 65B imposed a capital requirement and a liquidity margin for a registered dealer. Unless the Taxpayer met these requirements, it would not be able to carry out its business as investment adviser and manager.

42. Article 5 of the subordinated loan agreement stated that the loan was subject to the repayment approval by the Securities and Futures Commission. Article 9 of the agreement elaborated on the subordinated nature of the loan. The rights of Bank M were subordinated to all liabilities of the Taxpayer and repayment of whether principal or interest were conditional upon the satisfaction of specific conditions. The subordinated loan agreement did not mention any security or guarantee for the loan and according to the notes to the relevant accounts of the Taxpayer, the loan was unsecured and subordinated. It was included in the calculation of the required liquid capital but not for the ranking liabilities.

43. The subordinated loan must have been accepted by the Securities and Futures Commission as meeting the requirements of section 65B. It remained in place until 19 April 1994 when it was replaced by a new subordinated agreement. Instead of just the Taxpayer and Bank M, the new agreement was also signed by the Securities and Futures Commission.

The loan was for the same amount. The new agreement was necessary because section 65B had been replaced by Finance Resources Rules made under section 28 of the Securities and Futures Commission Ordinance. According to the preamble of this new subordinated agreement, the loan was to assist the Taxpayer in complying with the Financial Resources Rules and the Securities and Futures Commission had agreed to treat the loan as an approved subordinated loan for the purposes of compliance by the Taxpayer with the Financial Resources Rules. The new subordinated loan agreement is not strictly relevant to the year under review but it does throw some light on the nature and purpose of the earlier subordinated loan with which we are concerned.

44. The loan was drawn down on 27 December 1990 and immediately put back into Bank M as a deposit. The deposit was for one month but with standing instruction to roll over automatically on the same terms until further instruction from the Taxpayer. According to the accounts of the relevant year, the interest payable by the Taxpayer to Bank M for the loan was $1,511,410 while the interest receivable by the Taxpayer for the deposit with Bank M was $1,310,128. The latter was not taxable income as it was offshore interest.

45. The Commissioner has disallowed the whole sum of $1,511,410. He found that the loan interest incurred was of a capital nature and not deductible by virtue of section 17(1)(c) of the IRO. Alternatively he found that the interest expense had not satisfied the conditions set out in section 16(1)(a). The money from the loan was employed to fund a deposit and the income therefrom was not assessable to tax. In other words, the interest was not incurred in the production of chargeable profits. The Taxpayer appealed.

THE TAXPAYER'S CASE

46. The Taxpayer's case is very simple. The subordinated loan agreement states the purpose of the loan. The purpose was accepted by the Securities and Futures Commission. It was described as unsecured and there was no evidence to contradict that. Without the subordinated loan, the Taxpayer would not have met the liquidity margin required for a registered security dealer then stated in section 65B of the Securities Ordinance and it would not have been able to operate as a registered security dealer and accordingly would not have been able to generate income subject to profits tax.

THE REVENUE'S CASE

47. Mr So abandoned the argument that the loan interest incurred was of a capital nature. We were at one time concerned as to whether the maintenance of the liquidity margin would satisfy the requirement in section 16(1) where expenses had to be incurred for the production of profits. However Mr So informed us that the Revenue accepted that if we found that the interest was wholly incurred for the maintenance of the liquidity margin, then we should allow the appeal.

48. Mr So argued that the maintenance of the liquidity ratio was merely an incidental purpose. The main purpose was for the loan to generate a non taxable offshore interest. He went further to say that section 16(2) was probably not satisfied. He urged us to

find that there was in effect an undertaking given by the Taxpayer to repay because the loan was immediately redeposited back with the lender, thus the lender in effect had security or guarantee for repayment.

49. Finally, Mr So said that we should not allow a deduction for the entire amount of the loan interest because the real cost to the Taxpayer was only the difference between the loan interest and the non taxable deposit interest. We should effect an apportionment under Rule 2A of the Inland Revenue Rules.

REASONS FOR DECISION

50. We are satisfied that the subordinated loan did assist the Taxpayer in maintaining the liquidity margin. We accept that it was unsecured. Being subordinated, it was not repayable until all the other liabilities of the Taxpayer were repaid and all the conditions laid down by the Securities and Futures Commission were satisfied. Thus we do not see how there could have been any implied undertaking as contended by Mr So. We do not see any problem with section 16(2)(d). The problem is with section 16(1). The Taxpayer can only claim a deduction for outgoings and expenses incurred to the extent to which they are incurred in the production of profits chargeable to profits tax. The loan was not ploughed back into the general funds of the Taxpayer's business. It was redeposited to earn an interest which was not chargeable to tax. Thus the actual outgoing or expense to the Taxpayer or the extent of such outgoing or expense incurred in the production of chargeable profits tax was only the net difference between the loan interest of $1,511,410 and the non taxable deposit interest of $1,310,128. We are not sure that this is a case of apportionment under Rule 2A of the Inland Revenue Rules for it cannot be said that part of the interest was incurred for one purpose and part for another. But we find that deductible outgoing or expense was only the actual cost incurred in the production of taxable profit.

51. For reasons given, we allow the appeal in part by varying the Commissioner's Determination in respect of the loan interest and allow a deduction of $201,282 under section 16 and dismiss the rest of the appeal. It remains for us to thank the very clear and helpful submissions put forward by representatives from both sides for which we are deeply indebted.