Case No. D7/87

Board of Review:

H. F. G. Hobson, *Chairman*, Robert G. Kotewall and T. Y. TSE, *Members.*

26 May 1987.

Profits Tax—whether monies paid out by the Appellant to redeem a guarantee it had given for a customer to support the latter's continued trading with the taxpayer deductible under S. 16(1) of the Inland Revenue Ordinance.

The Appellant operates as a broker of gold, silver buying or selling the paper equivalent of that commodity for its customers and on occasion for its own account. The Appellant had tenuous relationship with a Deposit Taking Company. A customer approached the Appellant to open a "free" margin account, and to secure guarantees the Appellant ensured that the customer also operated an account with that Deposit Taking Company. Against this background a series of transactions occurred which resulted in a loss of approximately HK$3 million being the redemption of the guarantee given to the Deposit Taking Company by the Appellant on behalf of the customer. The revenue contended that the guarantee given to the Deposit Taking Company was in the nature of capital and hence debarred from set off against taxable profits by reason of S. 17(1)(*c*) of the Inland Revenue Ordinance.

Held:

The amount of guarantee paid out by the Appellant is a deductible expense for the following reasons:—

(*a*) Its object was to give greater credit to the customer whereby increasing the potential day to day business of the Appellant.

(*b*) No loan was made to the customer, but only an overdraft facility up to a certain amount.

(*c*) In none of the decided cases quoted did the guarantor have any control over the loan or sum guaranteed. However in the present case the Appellant exercised some control over the customer.

(*d*) The risk the Appellant ran was directly related to the orders they chose to fulfill for the customer in their day to day relationship.

Appeal allowed.

Cases referred to:

Anglo Persian Oil Company Limited v. Dale 16TC 253
Atherton v. British Insulated & Helsby Cables Limited 10TC 155
Charles Marsden & Sons Limited v. C. I. R. 12TC 217
Commonwealth Taxation Board of Review No. 3 15 CTBR (NS) Case 65 and 8 CTBR (NS) Case 17
C.I.R. v. Huntley & Palmers Limited 12TC 1209
English Crown Spelter Company Limited v. Baker 5TC 327
Henderson v. Meade-King Robinson Company Limited 22TC 97
Homelands (Handforth) Limited v. Margerison 25TC 414
Jennings v. Barfield 40TC 365
Lunt v. Wellesley 27TC 78

S. P. Barns for the Commissioner of Inland Revenue.
Christopher C. CHAN of Messrs. WOO KWAN LEE & LO for the Appellant.

Reasons:

Central to this appeal is the question whether monies paid out by the Taxpayer, to redeem a guarantee it had given for a customer to support the latter's continued trading with the Taxpayer, were deductible under s. 16(1) of the Inland Revenue Ordinance.

We do not think that it is necessary for the purposes of this Decision to set out in extenso the lengthy agreed facts or the oral testimony given by three witnesses for the Taxpayer. Accordingly the following is a somewhat simplified version and constitutes the main primary facts upon which this decision is arrived at.

1. BACKGROUND

1.1 The Taxpayer, an unincorporated firm wholly owned by a private limited company, operates as a broker of gold, silver buying or selling the paper equivalent of that commodity for its customers and on occasion for its own account.

1.2 A certain Mr. F who was both a Taiwan businessman and a Hong Kong newspaper publisher, approached the Taxpayer to open a "free" margin account, that is to say the customer's sales or purchases of gold would be unsecured (save in the case of purchases by the paper bullion itself or in the case of shorting, the market value of gold to match the purchase) but if the market value of his gold purchases dropped, calculated from day to day so long as he retained the gold, he would be required to pay the Taxpayer cash to meet the difference. On the other hand if the customer was shorting (selling without having the bullion on the expectation of the price dropping) then margin calls would be made to make for the difference on the market value increasing beyond his sales price. Naturally the Taxpayer could restrict the "free" margin by refusing to fulfill buy or sell orders for which the customer had no matching sell or buy on his account. There was in practice therefore a limit to the margin.

1.3 The Taxpayer being tenuously related through various share structures to a Deposit Taking Company (late to become a bank but the difference is not material to this Decision) encouraged its customers to open accounts with that Deposit Taking Company ("DTC"). F had such an account from the outset.

1.4 At the same time that F opened his account with the Taxpayer he also signed a letter (the "L/A") authorizing, inter alia, the DTC to debit his account …. "for any amount payable to the Taxpayer for settlement of my dealings and transactions with the Taxpayer" (including calls to satisfy margin requirements). Though the L/A was unqualified as to amount and though no evidence was led on the point we assume, as would normally be the case that the DTC could refuse to debit the account (and credit the Taxpayer's account) if the effect would be to carry the account into overdraft—the L/A therefore had an implicit qualification. Evidence was given, which we accept that the Taxpayer would only use the L/A in case of need i.e. when they could not contract F or he failed to respond with the necessary cash to meet the shortfall.

1.5 From the outset on the 31 October 1979 F shorted the market, entering into 19 contracts down to 12 January 1980.

1.6 On the 19 December 1979 F mortgaged certain properties to the DTC as security for overdraft facilities of up to $3.8 million.

1.7 Shortly after this F asked the Taxpayer to increase his margin thereby allowing to increase the scope of his order. To this the Taxpayer agreed provided that Mr. F. executed a further charge to the DTC for $3,500,000. The DTC were only agreeable to this if the Taxpayer would undertake to meet any losses which they might incur on realization of the further charge. The Taxpayer gave a guarantee which was conditioned upon such realization. Whereas the further charge was dated the 4 January 1980, it seems that the Taxpayer gave F the extra margin around that date notwithstanding that the conditional guarantee bears the date 15 January 1980. However we cannot see nor was it apparent from cross examination that this discrepancy had any bearing on the issues before us. From the testimony it was apparent that the giving of this guarantee was quite an isolated event.

1.8 On the 12 January 1980, F bought gold thereby closing off his then outstanding sale orders suffering, after balancing, a loss over the period down to that date of HK$1.83 million and US$235,818 (some of which was attributable to interest charged by the Taxpayer for the margin credit). This aggregate loss arose out of the 19 orders he laid which totaled a shorting of 32 200 taels of gold.

1.9 Thereafter F continued to trade and the Taxpayer allowed him credit on the strength of the further charge, which we accept was intended to be earmarked for his gold transactions.

From the 12 January 1980 until the Taxpayer was itself forced to liquidate all outstanding deals on the 19 January 1981—due to Mr. F's failure to meet further margin calls over and above those covered by the L/A—F had 26 transactions involving some 49 600 taels of gold: substantially greater than transactions conducted prior to the execution of the further charge.

1.10 The direct losses which the Taxpayer suffered on the aforesaid liquidation was US$155,474 (HK$820,800) and the Inland Revenue had no quarrel with the provision to that extent shown in the Taxpayer's account for the year ending 31/12/80.

1.11 Subsequently the DTC called upon the Taxpayer to pay under the conditional guarantee but the latter insisted that the DTC first realize the mortgaged properties. This was done over a period of time. An argument arose between the Taxpayer and the DTC as to precisely how much the former was owed by the Taxpayer. In the end they settled for HK$3 million which was paid on the 31/3/83. In the meantime the Taxpayer instituted proceedings against F and obtained default judgment for US$155,474.22 on the 13 May 1982.

2. *LEGAL ISSUES*

2.1 In a nutshell the main contention of the Inland Revenue is that the HK$3 million last referred to is in the nature of capital—or perhaps more accurately that the guarantee given to the DTC was in the nature of capital and hence debarred from set off against taxable profits by reason of s. 17(1)(*c*) of the Inland Revenue Ordinance.

2.2 Mr. S. P. Barns appearing for the Revenue cited three cases. In the first (CTBR (NS) Vol. 8 case 17) a personal guarantee was given to support loans to a car dealer in the expectation that the latter would pass business to the Taxpayer—a Hire Purchase company—owned by the guarantor. The car dealers business failed whereupon the Taxpayer took over the guarantor's commitments and met the guarantee. The Board of Review held that the losses on meeting the guarantee were in the nature of capital losses mainly due to the influence of the decisions in Charles Marsden & Sons Ltd. v. C.I.R. (1919 12TC 217) English Crown Spelter Co. Ltd. v. Baker (1908 5TC 327) and C.I.R. v. Huntley & Palmers Ltd. (1928 12 TC 1209).

In the second case (15 CTBR (NS) Case 65) the Taxpayer, a director of a hire purchase company, in his individual capacity provided accounting services for which he was remunerated separately on a commission basis. On occasions he guaranteed repayments of certain loans under recourse agreements by the Company to a third party car dealer. The third party having gone bankrupt the Taxpayer met the guarantee and submitted that his loss was a trading loss because the giving of the guarantee enhanced his potential commissions. The Chairman of the Board,

taking the view that there was some analogy between investment in shares where the return is small but potential losses are disproportionate and that in so far as a guarantee is undertaken to secure a source of income then payments required to be made would seem to be associated with the acquisition of a position from which to earn income rather than with the day to day revenue costs of deriving income, took the view that the guarantees were capital in nature.

The third case Meadowcroft v. C.I.R. (13 ATD 290) concerned an individual taxpayer who guaranteed the overdraft of a company engaged in exporting logs and was to be rewarded by fees as each shipment was made as well as certain other benefits. Judge Haslam in that case noted the distinction in the motive behind that Taxpayer's decision to give guarantee and those in reported cases i.e. there was nothing in the nature of an initial outlay which was converted into an asset of advantage to himself nonetheless he found that the profit to which he was entitled in the event of success was obviously the fruits of an enterprise which was made possible only by the risk of the appellant's capital. (It is unclear from the report whether the fees would be treated as taxable income or capital gains).

2.3 Mr. Barns submitted that there is essentially no difference between the Taxpayer having loaned a capital sum of HK$3.5 million to F to establish his financial base for doing business with the Appellant and the giving of the guarantee. We shall revert to this later.

2.4 Mr. Chan referred us to seven other cases viz:—

2.4.1 The House of Lords case Atherton v. British Insulated & Helsby Cables, Ltd. (10TC 155) where the Taxpayer paid a large lump sum into a pension fund as a nucleus and to ensure equity for existing employees. The following passage was cited to us for the guidance it offered:—

"But when an expenditure is made not only once and for all, but with a view to bringing into existence an asset or advantage of enduring benefit of a trade, I think there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital" (per Viscount Cave LC who then gave examples drawn from other decisions).

2.4.2 The Court of Appeal case of Morley v. Lawford & others (14TC 229). The Taxpayer had put up a guarantee in the expectation of receiving a contract for work to be done at the 1923 British Empire Exhibition. The General Commissioners found for the Taxpayer, Rowlatt J for the Crown but the Court of Appeal considered that there were no grounds for disturbing the Commissioners' decision. The case itself is not helpful to us because it is a case which "depends entirely upon its own special facts and will not offer a guide at all to future cases" (Lord Hanworth MR).

2.4.3 Anglo-Persian Oil Company Ltd. v. Dale (16TC 253) where the Court of Appeal held that a lump sum paid in commutation or to buy off recurrent and mounting commissions was an allowable deduction, basically because the commissions themselves would have been deductible.

2.4.4 In Henderson v. Meade-King Robinson Co. Ltd. (22TC 97) a loan by the Taxpayer made to a third party to enable the latter to invest in a whaling company on the understanding that the Taxpayer's agency would continue as sole agent for the borrower's business the unrecovered loan was found to be capital in nature. Lawrence J said that "the question in every case is what is the object of the expenditure" …. "was the object of the payment of a capital nature".

2.4.5 The peculiar circumstances of Homelands (Handforth) and Ltd. v. Margerison (25TC 414) and Lunt v. Wellesley (27TC 78) are such that nothing useful can be derived from the judgments so far as concerns the case before us: moreover the Homelands case contains no explicit reasons for the findings.

2.4.6 In Jennings v. Barfield (40TC 365) on appeal the General Commissioners' finding that monies paid under a guarantee given by solicitors on behalf of their clients was so common that it was regarded as part of their business and hence a deductible expense was upheld. As Mr. Chan hastened to acknowledge the finding appeared to turn on the regularity of the practice of guaranteeing clients, a feature not present with the isolated guarantee for F.

3. DECISIONS

3.1 In our opinion the HK$3 million which was paid out by the Taxpayer is a deductible expense for the following reasons:—

3.1.1 Its object was to give greater credit to F thereby increasing the potential day to day business of the Taxpayer.

3.1.2 We believe that it is quite easy to distinguish the facts in this case from the Taxpayer making a loan of HK$3.5 million to F (see 2.3 above) because no loan of HK$3.5 million was made; Mr. F was given an overdraft with a facility of up to that amount. We find it much more analogical to compare that transaction with the Taxpayer itself taking the further charge (if the DTC had permitted it) and granting F credit of up to HK$3.5 million: in which case the losses like, the direct losses referred to in 1.10 above, would unquestionably have been deductible.

3.1.3 Most of the cases to which we were referred dealt either with a lump sum loan or a guarantee of a lump sum (or in the Meadowcroft case an overdraft). In none of these cases did the guarantor have any control over the loan or sum guaranteed. However in the instant case the Taxpayer, by refusing to accept an order from F, or for that matter at any stage liquidating his portfolio, did have control. In short the risk the Taxpayer ran was directly related to the orders they chose to fulfill for F in their day to day relationship—the very same risk, with the very same object, as the HK$820,800 (1.10 above) they lost directly following the January 19, 1981 liquidation of his portfolio.

3.2 Accordingly on that aspect we find for the Taxpayer.

4. TIMING

4.1 An ancillary question arises to which we have not so far referred, namely was the Taxpayer properly entitled to make a tax deductible provision in the year ended 31.12.81, rather than in 1983 when the Taxpayer paid the HK$3 million.

4.2 Mr. Barns acknowledged that the Privy Council decision in Lo and Lo (HKTC Vol. 2 p. 34) made it clear that tax deductions are not confined to sums actually paid nor is an expense incurred confined to an actual disbursement. However he argued that insufficient evidence existed on the 31 December 1981 that there was an obligation on the Taxpayer to make a payment under the guarantee: did the DTC at that time have a present right to demand payment bearing in mind that the DTC had first to sell the mortgaged properties (as required by the footnote to the guarantee) before it could ascertain the amount its losses on the further charge before it could call upon the Taxpayer to reimburse it? Mr. Chan replied that the DTC could have obtained a declaration of indemnity against the Taxpayer—but even if that is correct the indemnity would be for an unascertained amount. However we are not convinced that Lo and Lo supports the proposition that the accrued obligation needs to be an ascertained amount (at least for the purposes of the instant case).

4.3 In the event the third witness, Mr. W, a certified accountant who audited the Taxpayers' accounts gave evidence; which we accepted, that some properties were sold in 1981 and in November 1981 the remainder were valued at HK$5.9 million versus a total of HK$7.8 million due from F. HK$1.9 million was uncovered. But because the Taxpayer could not control the sale of the properties and because interest would accrue on F's overdraft with the DTC it was decided as prudent and in accordance with accepted principle of commercial accountancy practice to make a provisions of HK$3.5 million plus HK$0.5 million for legal and other costs. Mr. W's evidence was not challenged in cross-examination.

4.4 In the light of the foregoing we are of the opinion that it was proper to make the 1981 provision to the extent mentioned and would allow the same but recognizing

that in the event the figure was HK$3 million, $1 million would have to be written back. We think that as of now the provision for tax purposes should be taken to be $3 million for the tax year 1982/83 (in the basis year ending 31.12.81).