Case No. D8/89

Profits tax – deductions – borrowing expenses – whether borrowing expenses can be deducted if of a capital nature – ss 16(1)(a) and 17(1)(c) of the Inland Revenue Ordinance.

Profits tax – deductions – borrowing expenses – whether exchange losses on the repayment of a loan are 'expenses in connexion with … borrowing' and therefore deductible – s 16(1)(a) of the Inland Revenue Ordinance.

Profits tax – deductions – exchange losses incurred by trading company – whether losses were of a revenue or capital nature – ss 16(1) and 17(1)(c) of the Inland Revenue Ordinance.

Panel: Denis Chang QC (chairman), Frank Pong Fai and Alexander Woo Chung Ho.

Dates of hearing: 10 and 11 August 1988.
Date of decision: 20 April 1989.

The taxpayer company carried on a business of trading in goods. It borrowed funds in US$ from a bank, having represented to the bank that the funds were being borrowed to finance purchases of trading stock. However, the Board found that the funds were in fact borrowed for the purpose of enabling the taxpayer to make those funds available to its parent company to enable the parent to pay off certain debts.

The amount borrowed was large compared with the taxpayer's paid-up capital and reserves and even when compared with its sales. The funds were borrowed by means of the taxpayer accepting short-term bills which were rolled over on a monthly basis for 3-1/2 years. During that period, the borrowing featured prominently in the taxpayer's financial profile.

The taxpayer repaid its US$ borrowings by replacing them with HK$ borrowings and, in doing so, it incurred exchange losses. It claimed that the exchange losses were incurred on revenue account and were therefore deductible.

Held:

The exchange losses were incurred on capital account and were therefore not deductible.

(a) Exchange losses incurred in connection with a borrowing cannot be said to constitute ‘expenses in connexion with such borrowing’ so as to fall within the deductibility provisions of section 16(1)(a).

(b) Expenses which fall within the deductibility provisions of section 16(1)(a) will not be deductible if they constitute expenditure of a capital nature within the meaning of section 17(1)(c).

(c) Whether an expense is of a revenue nature or not depends on what the expenditure is calculated to effect from a practical and business point of view rather than on a strict legal classification of the rights involved.

(d) An exchange loss prima facie is of a revenue nature (and therefore deductible) if it is referable to the discharge of a liability on revenue account, that is to say, if the borrowing which gives rise to it is itself of a revenue nature. This would be the case if the purpose of the borrowing is the provision of mere temporary accommodation in the ordinary course of the taxpayer’s profit-making activities. In this case, although the borrowing took the form of monthly bills, in substance there was de facto continuation of the borrowing for 3-1/2 years.

(e) In determining the purpose of a borrowing, the use to which borrowed funds are put is evidence but is not necessarily conclusive. Likewise, the terms and duration of the loan are also not necessarily conclusive.

(f) A borrowing will be of a capital nature if its purpose is to add permanently to the capital structure of the taxpayer’s business. ‘Permanence’ in this context is a question of fact and degree. On the facts, the borrowing served to strengthen the capital base of the taxpayer.

(g) The accounting treatment of such loans in the taxpayer’s accounts is not conclusive of the proper tax treatment.

The decision contains a useful analysis of relevant UK and Australian case law dealing with the deductibility of exchange losses. It also contains a detailed analysis of the accounting treatment of short-term and long-term borrowings.

Appeal dismissed.

[Editor’s note; This decision can usefully be read in conjuction with D77/88, reported elsewhere in this volume. It should also be noted that the case of Beauchamp v F W Woolworth plc which is referred to in the decision has subsequently been overturned by the House of Lords on appeal, although the principle to which this decision refers was upheld. It should be noted that the Board’s comments concerning the interrelationship between ss 16(1)(a) and

17(1)(c) would seem to apply equally to payments of interest so as to deny deductibility for interest paid on capital account.]

Cases referred to:

Avco Financial Services Ltd v FCT (1982) 13 ATR 63
Beauchamp v F W Woolworth plc [1988] STC 714
BP Australia Ltd v FCT [1966] AC 224
Cadbury-Fry-Pascall (Australia) Ltd v FCT (1979) 79 ATC 4346
Caltex Ltd v FCT (1960) 8 AITR
Davies v The Shell Co of China Ltd (1951) 32 TC 133
FCT v Hunter Douglas Ltd (1983) 14 ATR 629
Hallstroms Pty Ltd v FCT (1946) 72 CLR 634
Montreal Coke & Manufacturing Co v MNR [1944] AC 126
Pattison v Marine Midland Ltd (1983) 57 TC 219
Scottish North American Trust Ltd v Farmer (1911) 5 TC 693
Sun Newspapers Ltd v FCT (1938) 5 ATD 87
Thiess Toyota Pty Ltd v FCT (1978) 78 ATC 4463

S P Barns for the Commissioner of Inland Revenue.
David Flux of Peat Marwick for the taxpayer.

Decision:

The issue in this case is whether deductions are allowable in respect of certain exchange losses made by the Taxpayer company ('the company') upon repayment of US dollar loan facilities provided by a bank ('the bank'). The profits tax assessments in question are for 1981/82, 1982/83 and 1983/84.

Section 16(1) of the Inland Revenue Ordinance allows deductions for outgoings and expenses to the extent to which they are incurred in the production of assessable profits. However, under section 17(1)(c), 'any expenditure of a capital nature or any loss or withdrawal of capital' is not allowable as a deduction.

There is no Hong Kong authority directly in point although there are some UK and Australian authorities which throw some light on the problem.

A distinction should be made at the outset between an exchange loss which forms part of the cost of trading stock and one which does not.

The Revenue accepts that a deduction is always allowable for the full cost of trading stock since the buying and selling of trading stock is clearly on revenue and not on capital account.

What is referred to as an exchange loss is sometimes simply a part of the cost of trading stock and hence an allowable deduction. Where, for example, a Hong Kong trading company purchased trading stock from the US at a unit cost of US$20 when the exchange rate was $6.3 to US$1 and, at the time of payment, the rate had moved to 7.8 to US$1, the company would have to pay out $156 as compared to $126 at the time of purchase. The extra $30 'exchange loss' would in reality be an additional cost of the trading stock and would thus form an allowable deduction.

An exchange loss, however, could arise upon repayment of a loan in circumstances which would not make the expenditure part of the cost of trading stock. The expenditure could nonetheless still be incurred on revenue account. Whether it was so incurred or not would depend on the facts.

If a company borrowed, say, US$1 million when the exchange rate was, for example, 6.3 to 1 and the rate had moved to, say, 7.8 to 1 at the time or repayment, the company would have to find a total sum of $7,800,000 to repay the principal as compared with $6,300,000 received at the time of the loan. The exchange loss would be $1,500,000. The fact that it arose out of repayment of a loan would not, by itself, dispose of the issue as to whether it was of a revenue or capital nature. That would depend on whether the loan itself was obtained on revenue or capital account.

An exchange loss referable to the discharge of a liability on capital account is prima facie itself on capital account and an exchange loss referable to the discharge of a liability on revenue account is prima facie itself on revenue account. Accordingly, it is necessary to look, among other things, at the nature of the loan which gave rise to the liability.

In the present case, a loan facility was made available by a bank to the company totalling US$2 million which was drawndown in two tranches, one on 27 October 1981 and the other on 24 November 1981, by the acceptance of bills of exchange (so-called 'bankers' acceptances') of US$1 million in each case. The bills of exchange were discounted with the bank for US$958,666.67 (being US$1 million discounted at 16% for three months) and US$984,950 (being US$1 million discounted at 12.9% for six weeks).

The maturity dates of the bills, that is, the dates on which the money borrowed were required to be repaid by the company were, therefore, 28 January 1982 and 5 January 1982 respectively.

Upon the maturity dates of the bills, the liabilities were renewed in the manner described below. Because of movements in the exchange rate, the Hong Kong dollar amounts required to repay the US dollar loan facilities exceeded the Hong Kong dollar equivalents of the same US dollar amounts as at the respective dates the monies were advanced by the bank. The excess represents the losses on exchange.

The actual losses claimed on exchange were $26,700 for the year ended 31 March 1982, $1,746,000 for the year ended 31 March 1983 and $1,343,000 for the year ended 31 March 1984. We understand that these figures were arrived at as a result of a convenient method of apportionment adopted by the company but, for the purposes of the relevant assessments and of this appeal, the Revenue does not dispute quantum and both sides are asking us to proceed on the basis of an 'all or nothing' claim.

We are also asked to assume that the losses claimed were realised losses notwithstanding the fact that, upon maturity of the aforesaid bills of exchange, the company met the face value by accepting further bills of exchange likewise discounted but at maturities of between one to two months and generally of around one month.

It is not in dispute that the aforesaid method of renewing the liabilities to the bank continued until about February 1985 when the outstanding bills were all repaid in one go by means of an amount of some $14,500,000 made available by the bank through an overdraft facility which it granted to the company for the purpose.

It is common ground that the overdraft itself was repaid over a period of some 9 months. For quite some time even prior to the obtaining of the overdraft facility, however, the company had – following the Hong Kong monetary crisis of September 1983 – been taking out the bankers' acceptances in Hong Kong rather than US dollars and therefore no exchange losses had thereafter arisen or had been claimed in connection with the transactions.

It is common ground that the company was incorporated as a private company in Hong Kong on 28 August 1961 and at all times carried on the business of importers, exporters and general merchants and was a member of a group of companies dealing in various products.

At all material times, the company purchased goods from its holding company, X Limited, which was a listed company incorporated in Hong Kong and which owned 100% of the issued share capital of the company. X Limited in turn purchased the goods through or from one or other of its associated companies in Singapore.

It is likewise common ground that the company's books included a current account with X Limited (reproduced as appendix B to the Commissioner's determination, covering the periods between 1 April 1979 to 31 March 1983).

Appendix B shows, among other things, that X Limited was credited with sums against items which were prior to October 1981 described as goods supplied and thereafter identified simply by reference to numbered X Limited invoices. Dividends payable by the company to X Limited were also credited to the account. The debit items included regular and other payments in partial settlement of the account.

Among the debit items shown in the said current account were two payments, denominated in Hong Kong dollars, which were funded by and which used up the proceeds of the loan from the drawdown by the company of the original bank facility on 27 October 1981 and 24 November 1981 respectively as aforesaid.

These two items, we find as a fact, represented the equivalent in Hong Kong dollars of the net proceeds of the US dollar loan in two tranches which the company had in each case caused the bank to remit, after direct conversion into Singapore currency, to or for a designated account in Singapore in accordance with X Limited's instructions. As between X Limited and the company, the remittances were for the account of X Limited. The payments thus came to be reflected in the said current account.

Accordingly, as between the bank and the company, the loan facilities were in US dollars and were to be repaid in US dollars. As between X Limited and the company, the currency of account and of payment was Hong Kong dollars.

The section 16(1)(a) argument

The company's first contention is that, in addition to interest on borrowed money (represented by the amounts discounted in respect of the bills and which is not the subject of dispute in these proceedings), deductions should be allowed in respect of exchange losses under section 16(1)(a) irrespective of whether the losses were referable to revenue or capital account.

As we understand it, the argument proceeds on the premise that what is included in section 16(1)(a) is deemed to be deductible notwithstanding the exclusionary provision of section 17(1)(c) and that the exchange losses in question fell within the rubric of 'sums payable by way of legal fees, procuration fees, stamp duties and other expenses in connexion with such borrowing'.

We are unable, however, to accept the argument. Section 16(1)(a) does not in terms exclude section 17 unlike sub-paragraph (g) thereof which is expressed to operate 'notwithstanding section 17'. Furthermore section 17 in our view is not by necessary implication excluded in relation to the type of expenditure with which we are here concerned, whatever might be the position in relation to other specific-identified items of expenditure.

In our opinion, the general formula 'other expenses in connexion with such borrowing' should be construed in its context to refer to a category of transaction costs similar to those specifically enumerated (legal fees, etc). We do not think exchange losses fall into that category.

Alternatively, we hold that exchange losses of a capital nature cannot be turned into an allowable deduction in the teeth of section 17.

When is an exchange loss on repayment of loan a deductible expense?

An exchange loss of a revenue nature would however qualify for deduction under the general rubric of 'outgoings and expenses' contained in section 16(1) to the extent it was incurred during the relevant basis period in the production of profits chargeable to tax.

Whether an exchange loss is thus deductible turns on questions of act and degree. The answer depends on what the expenditure is calculated to effect from a practical and business point of view rather than a juristic classification of the legal rights involved: Dixon J in Hallstroms Pty Ltd v Federal Commissioner of Taxation (1946) 72 CLR 634, 648, cited with apparent approval by Lord Pearce when delivering the judgment of the Privy Council in BP Australia Ltd v Federal Commissioner of Taxation [1966] AC 224, 264.

While neither case referred to above dealt with exchange losses, the judgments dealt with the difference between expenditure on revenue account and expenditure on capital account. This was said to correspond to the distinction between (1) the business entity or structure and (2) the process whereby the business operates to obtain regular returns by means of regular outlay: per Dixon J in Sun Newspapers Ltd v Federal Commissioner of Taxation (1938) 5 ATD 87, a decision of the Australian High Court.

In Hallstroms (above), Dixon J (at 646) further suggested that the difference corresponds to the distinction between acquisition of the means of production and the use of them; between establishing or extending a business and carrying on the same; between implements employed and the regular performance of the work in which they are employed; between an enterprise itself and the sustained effort of those engaged in it.

Thus, a distinction has to be made between the capital which enables a business enterprise to be conducted and the activities by which the profits of the business are earned. 'Expenditure incurred in relation to the financing of a business is not expenditure incurred in the earning of the income of that business', per Lockhart J in Federal Commissioner of Taxation v Hunter Douglas Ltd (1983) 14 ATR 629, 645, quoting Lord Macmillan in Montreal Coke & Manufacturing Co v Minister of National Revenue [1944] AC 126 at 134.

In Hunter Douglas, certain exchange losses arose out of repayment by a manufacturing and marketing company of credit facilities it had obtained in foreign currency. The company was proposing to expand its business and required additional finances in order to meet the day-to-day running of the business. The drawdowns were actually so used - to pay for wages, pay-roll tax and stock-in-trade. The court nevertheless, by a majority (Franki J dissenting), restored the Commissioner's determination that the exchange losses claimed were of a capital nature.

Fisher J and Lockhart J proceeded on the basis that, in general, loans and repayments of loans are considered to be on capital account and that borrowing money to carry on business or to pay liabilities incurred in carrying on business is prima facie to

increase the capital employed in the business: citing Caltex Ltd v Federal Commissioner of Taxation (1960) 8 AITR at 251 per Menzies J and Avco Financial Services Ltd v Federal Commissioner of Taxation (1982) 13 ATR 63, 68 per Mason, Aickin and Wilson JJ.

If, however, the borrowing formed an integral part of the profit-making activities or process by which the business operated to obtain its regular returns, both Fisher J and Lockhart J considered that the borrowing and the exchange loss made on repayment would be affairs of revenue. This, they held, was the position as regards borrowings by finance companies in the ordinary course of their business and by trading companies in circumstances where the borrowing was a necessary part and had the purpose of purchasing trading stock. They compared Commercial & General Acceptance Ltd v Federal Commissioner of Taxation (1977) 77 ATC 4375 with Avco (above) and cited the Thiess Toyota Pty Ltd v Federal Commissioner of Taxation (1978) 78 ATC 4463 and Cadbury-Fry-Pascall (Australia) Ltd v Federal Commissioner of Taxation (1979) 79 ATC 4346 line of cases.

The learned judges held that, on the facts, the borrowings and exchange losses were not an integral part of the ordinary operation of the taxpayer's business so as to represent a matter of revenue rather than capital. They were of an exceptional nature related to the financing of the taxpayer's business by augment its working capital. Their purpose was to provide a stronger base or entity with which to carry on the taxpayer's business (Lockhart J at 645; Fisher J at 642).

A number of UK authorities have also been cited to us, including the recent decision of the Court of Appeal in Beauchamp v F W Woolworth plc [1988] STC 714. The Court of Appeal, reversing the decision of Hoffman J [1987] STC 279, affirmed the general principle that losses incurred in connection with loan repayments would only be deductible if the loan themselves were part of the taxpayer company's revenue transactions and were not accretions to capital.

The special commissioners whose decision was restored by the Court of Appeal in the Woolworth case clearly thought it significant that the taxpayer company was not seeking to add permanently to its capital structure but was dealing with what appeared to be short-term problem of cash shortage. The fact that the loan in question was for a period of five years was considered by the commissioners to be the strongest factor in the Crown's argument, but the commissioners disagreed that this was in any way decisive.

In the Woolworth case, many of the UK authorities were reviewed, including Scottish North American Trust Ltd v Farmer (1911) 5 TC 693 which related to interest payable on a fluctuating overdraft and on a six-month loan (see Lord Atkinson at 127 and Lord Johnston in the Court of Session 5 TC 693 at 698); Davies v The Shell Co of China Ltd (1951) 32 TC 133 (see Jenkins LJ's dictum at 157 on the prima facie 'capital' nature of monies obtained on loan); and Pattison v Marine Midland Ltd (1983) 57 TC 219 (see, in particular, Vinelott's exposition of the difference between 'fixed' and 'circulating' capital at 159-166 and at 169).

While some of the UK authorities appear to focus on the temporary or permanent nature of the advantage sought to be gained, most of the Australian authorities appear to focus on whether the expenditure was incurred as part and parcel of purchasing stock by trading companies or in the ordinary course of dealing in money by finance companies.

Both the UK and the Australian authorities, however, are agreed that the use to which the money was put would not be conclusive. Both also agree on the need to ascertain whether the borrowing was an ordinary incident of trading. Furthermore, Lord Macmillan's dictum in Montreal Coke (above) has been relied upon in Australia for the distinction between expenditure incurred in financing the business and that incurred in the very process of profit-making activities.

In the context of our own revenue legislation, it may be useful to set out the general lines of approach which we propose to adopt:

1. An exchange loss would be an expense or outgoing of a revenue nature if the borrowing which gave rise to it was itself of a revenue nature.

2. A borrowing would generally be of a revenue nature if its purpose was the provision of mere temporary accommodation in the ordinary course of the taxpayer's profit-making activities.

3. The use to which the funds were actually put might be evidence of the purpose of the borrowing but would not necessarily be conclusive of it.

4. The terms and duration of the loan would not be necessarily conclusive of its purpose or character.

5. A borrowing would clearly be stamped with a capital nature if its purpose was to add permanently to the capital structure of the taxpayer's business. 'Permanance' is a relative term involving matters of fact and degree.

6. Broadly speaking, whether an expense incurred was of a capital or revenue nature would itself be a matter of fact and degree turning largely on what the expenditure was calculated to achieve from a practical and business point of view.

Were the exchange losses of a revenue nature?

Mr S P Barns, who appears for the Revenue, contends that the expenditure was not incurred as an integral part of purchasing stock nor was it otherwise an ordinary incident of the company's trade.

Mr D Flux of Messrs Peat Marwick, who represents the company, submits that the loan facilities obtained were nothing more than temporary accommodation for the purchase of trading stock.

Oral evidence was given on behalf of the company by Mr A, managing director of the company as well as of X Limited, and by Mr B, a certified public accountant and partner of Peat Marwick. Peat Marwick was at all material times the auditor of the company.

The documentary evidence included letters evidencing the loan facilities from the bank, various annual tax returns and audited accounts of the company and, of course, the said current account (Appendix B).

The initial offer of facilities from the bank was by way of a letter dated 28 September 1981 addressed to Mr A as managing director of X Limited.

The letter described the US$2 million line as being 'for various short-term import/export bills and trade financings' and also offered an overdraft facility of HK$3,000,000 stating that the aforementioned facilities were of 'normal short-term nature ... subject to modification and cancellation at the bank's sole discretion'.

The security required comprised a pledge of 2.8 million shares in Y Limited which was a related company of company. It was X Limited, we find, which owned this block of shares. It was a term that the security should be topped up if the market value of the shares should drop below 80% of outstandings.

It was the bank, we find, which made the first approach to offer facilities to the X Limited group of companies following a chance meeting and renewal of friendship between Mr A and an old schoolmate of his, one Mr C, a vice-president of the bank.

The offer, though addressed initially to X Limited, was taken up by the company after some discussion between Mr A and the bank. The company took up the term loan facility in US rather than Hong Kong dollars because there was a perceived advantage in the lower interest rate (which was about 16% for the first tranche compared with the prime rate of around 20% for Hong Kong dollar loans).

It is an agreed fact that, at a directors' meeting held on 13 October 1981, the company resolved to accept the US dollar loan on the terms offered.

Two subsequent letters from the bank dated 27 October 1981 and 24 November 1981 respectively were addressed to and countersigned by the company. These letters evidenced the two drawdowns and the terms of the relevant bankers' acceptances.

Each tranche was made available not against shipping documents or by reference to the value of goods shipped but upon mere certification by the company that there existed an 'underlying transaction' involving merchandise 'in the channels of trade'.

Regarding the first drawdown, the underlying transaction was said to consist of 'two shipments' of products 'between September 1981 to October 1981' from Singapore to Hong Kong. The shipper's name given was Z Limited, Singapore and the consignee was said to be the company.

Regarding the second drawdown, the underlying transaction was said to consist also of 'two shipments' of the same type of goods 'between October 1981 to November 1981' from the same shipper to the same consignee.

The value of none of these shipments was stated, nor was any another relevant information given. There was no stipulation that the loan proceeds were or could be utilised only for meeting the company's liabilities relating to four specific shipments or indeed any specific debt. The company has not sought to argue that there was such a condition or that the money was borrowed to pay for <u>particular</u> shipments.

Neither the company nor X Limited in fact purchased goods directly from the said Singapore company and it was Mr A's evidence, and we find as a fact, that X Limited made use of the transferred funds to settle debts which X Limited owed to third parties, including a related company.

The Revenue submits that facts and matters exist which clearly attest to the exceptional nature of the borrowing and point to a financial exercise quite outside the company's day-to-day revenue earning activities. The Revenue relies in particular on the following matters.

1. The <u>entirety</u> of the loan was channelled for the use or account of X Limited despite the fact that, by the date of the second drawdown, the amount owing to X Limited was only $2,890,000. Yet some $5,600,000 was paid, turning the company into a creditor of X Limited.

2. The company nonetheless continued to pay substantial sums of money to X Limited, including $2,000,000 on 27 November 1981 and $1,000,000 on 17 December 1981.

3. By 31 March 1982, X Limited owed the company around $5,400,000 and, by 30 March 1983, the figure had risen to some $10,100,000 – one day before it was abruptly reduced by $5,500,000 by 'reverse' transfer of funds.

4 Indeed, throughout a period of at least two years from the date of the second drawdown, the said current account continued to show a generally substantial debit balance against X Limited.

5. There had previously been occasional debits but for much shorter periods. As appendix B reveals, at the end of October 1979, a debit in the sum of $611,000 showed up but disappeared over thirty days. In December 1979, another debit showed up increasing to $2,200,000, but this disappeared over ninety days. The account was otherwise generally in substantial credit in X Limited's favour, with month-end balances of around $8,000,000 – $10,000,000 in the months preceding October 1981.

6. The two year period of debit following the second drawdown largely coincided with the period over which the liabilities under the US dollar bankers' acceptances were renewed until 'replaced' by HK dollar bills of exchange following the September 1983 monetary crisis.

7. In the meantime, for the purpose of calculating the amount of interest paid by the company that was claimed as an allowable deduction, the company treated the credit balance in its favour in the sum of $5,400,000 as at the end of the 1981/82 year as 'a non-trading asset.' The same applies for 1982/83.

8. The debits in Appendix B referable to the two drawdowns were the two single largest sums charged against X Limited in the said account. There were no comparable debit items. The usual regular payments were in round sums of, or in the vicinity of, $100,000, $200,000, $300,000, $400,000 and less frequently $600,000 (apart from larger sums in respect of interim dividends payable by the company, including some $3,000,000 on 31 March 1982).

9. As Mr A has confirmed in his evidence, the usual regular payments were made not from any sort of loans but from the money that came in to the company from its sales of the goods.

10. Furthermore, as Mr A has also confirmed, the company was not in the habit of taking out other loans generally. The item 'bank advances and overdraft' (referable to the bank facilities) first appeared in the balance sheet of the company for the year ended 31 March 1982. It was and remained the only item of bank borrowing and disappeared four years later after the overdraft granted for the purpose of paying off the bankers' acceptances was itself repaid.

11. Notwithstanding the reference in the offer letter of 28 September 1981 to 'short-term' trade financings and the maturity dates of the individual bankers' acceptances, there were renewals of liabilities under bankers' acceptances until February 1985 – a period of just over 3 years and 3 months from date of first drawdown.

12. The paid-up share capital of the company at all times was just over $1,000,000 with retained profits of around $1,100,000 for 1980/81. The retained profits

dropped substantially to a little less than $390,000 for 1981/82 and still further to around $110,000 for 1982/83. There were accummulated losses to the tune of almost $290,000 in 83/84 and around $110,000 in 84/85.

The matters stated in items 1-12 above are indeed among the facts which we find to be clearly established on the evidence. We should add that, according to its audited accounts, the company had at all times few items by way of fixed assets: these comprised office equipment, etc valued at around $170,000 for 1981/82 and rose to no higher than $525,000 (the approximate figure for 1982/83).

The Revenue's representative says that the above (among other) facts are relevant when ascertaining the purpose and nature of the borrowing. It contends that the moneys obtained on loan were for capital accretion, enabling the company in effect to finance its holding company by transferring funds to X limited without any real reference to any specific invoiced debts <u>and</u> in excess of the amounts owing by the company.

Mr A, however, maintained that the loan was for payment of goods and nothing else and that there was nothing strange or unusual happening. The account, he said, was an active one and, with cost of sales averaging $37,000,000 per year, could run either way. When it happened to go into debit, he said, the company would be treated as paying for stock in advance.

Mr Flux for the company said that, on a first-in, first-out basis, the particular debit item resulting from the proceeds of the <u>second</u> drawdown would be eliminated at some stage down the line by invoices for goods supplied by X Limited. He said that, in any event, the amount owing to X Limited at the time of the <u>first</u> drawdown was in excess of the first tranche of the loan by around $2,000,000 (in Hong Kong currency).

We accept that the account was an active one and could go either way. The mere fact that the account went into debit proves nothing. On the other hand, we are not looking at an occasional debit. The said current account went and stayed in debit for upwards of two years producing an item (the 'non-trading asset') which in our judgment could not in the circumstances realistically be regarded as having for its purpose the payment of goods in advance and, incidentally, was not so treated in the audited accounts.

Mr B of Peat Marwick gave evidence to the following effect:

1. A bank <u>overdraft</u> would 'generally' be treated in the accounts as being part of the 'working' or 'circulating' capital on net current assets and would not increase the 'capital employed' which he understood to mean funds introduced by the proprietors including 'long-term' loan capital.

2. 'Long-term' loan capital would 'normally' be shown as a separate, sub-total underneath shareholders funds and would augment the capital employed

represented in the relevant balance sheets by 'share capital and reserves' (comprising share capital and retained profits).

3. To ascertain whether a loan should be treated in the accounts as part of the capital employed, he would need to see if it was funding of a relatively 'permanent' nature. A one-year term loan, for example, could be funding of a permanent nature. At the same time, he did not think that one year necessarily provided a dividing line between what should be treated in the accounts as capital employed and what was a matter of 'current liability'.

4. He thought, however, that the one-year limit would be a helpful 'indicator'. Using that indicator, he thought that loans shorter than one year would be obvious items for inclusion under 'current liabilities'; and, on the other side of the line, the longer the term the better would be the borrower's chance of making and retaining profits in the business in place of the borrowed funds when repaid and the greater would be the chances of the loan being an addition to the capital base prior to repayment.

5. In the case of 'short-term' loans constantly 'rolled-over' or otherwise renewed, he would need to look more into the factual basis to see, in particular, whether there was an assurance or commitment on the lender's part to renew. Even if there were such a commitment or assurance, he would have some difficulty in not putting the items under 'current liabilities' if the loans individually qualify for inclusion thereunder although a note to the accounts might serve to clarify matters.

6. The item 'group interests' shown in the balance sheets included moneys due to the subsidiary from the parent company. This asset (described in the accounts as a 'non-trading asset') would still form part of the working or circulating capital if <u>it was derived from the trade</u>.

We find the accounting evidence generally helpful in our understanding of accounting treatment but it is, of course, by no means conclusive either way of the issue we have to decide. We do not understand Mr B as saying that there is any rule – independent of the purpose of the borrowing or the particular circumstances of the case – that a loan shorter than one year will automatically be treated as of a revenue nature. In any event, we are not satisfied that there is any such a rule, nor do we accept the proposition that, unless the lender is committed to renewing it, a 'short-term' loan will always be of a revenue nature.

We think it important to look at the matter from a practical and commercial viewpoint. From that perspective, we have no difficulty in finding as a fact, which we do, that the borrowing in the present case had a continuity which was achieved by the renewals of the bankers' acceptances <u>without reduction of the outstanding amount</u>. Thus, for over three years, the same basic figure featured prominently as an outstanding bank loan in the financial profile of the company.

The amount outstanding was a significant and large figure when seen against the very much smaller paid-up capital and reserves of the company and even when compared with the annual average sales figure of some $43,000,000 for the three years in question. The debt owing to the bank stood undiminished right through and beyond the two year period during which the said current account (Appendix B) went into and stayed in debit. As mentioned above, the two year period largely coincided with the period over which the US dollar bankers' acceptances were renewed.

In short, despite the substantial sums owing by X Limited to the company on the said current account, the liabilities under the relevant bankers' acceptances were renewed. Thus, a state of affairs was maintained over the relevant period in which the company needed to have no resort to the 'non-trading asset' constituted by the moneys owing to the company from its parent company or to other resources in order to find the cash to pay off or reduce the outstanding indebtedness to the bank.

In our judgment, despite the fact that each bankers' acceptance was technically a 'brand new bill', as Mr Flux puts it, there was in substance on the facts of this case de facto continuation of the loan. The loan was not akin to the sort of overdraft described by Lord Atkinson in Scottish North American Trust Ltd v Farmer (above) as moneys borrowed in a 'fluctuating temporary manner', nor to the sort of short-term loans described as 'short in the sense of short and indefinite in duration, borrowed when occasion required, and repaid as opportunity permitted': Lord Johnson in the Court of Session in the same case [5 TC 693 at 698]. While the characteristics described are by no means essential for all loans of a revenue nature, they are helpful indicators.

It happened that most of the exchange losses occurred arose out of the renewals of liabilities under the bankers' acceptances. The sum of $26,700 claimed for 1981/82 was simply included in the cost of stock; the much larger sums claimed for each of the following two years appeared in the accounts under operating expenses.

We find as a fact that none of the expenditure claimed was incurred as an integral part of the company's regular process of profit-earning. It was not part of the cost of stock, nor was it in the nature of operating expenses. It was at best expenditure incurred in the financing of the business as distinguished from that incurred in the process of profit-making.

Unlike the case of Theiss Toyota Pty Ltd v Federal Commissioner of Taxation (above) which concerned payment of a draft drawn under a letter of credit arrangement made with a bank for goods shipped, the borrowing and the company's purchases of goods in the present case were separate and distinct transactions. In Theiss Toyota, the court found it impossible on the facts to separate the two transactions and in effect regarded the arrangement as in substance amounting to the substitution of the bank as creditor in place of the vendors of goods.

The loan in the present case was not obtained by the company to tide over any temporary cash flow problem as in the Woolworth case (above), and it is not so alleged. Nor do we find that it was mere temporary accommodation for the purchase of trading stock (as is alleged).

We find that the amount of borrowed funds which were caused to be transferred to X Limited was in no way decided upon by reference to any outstanding trade debt between X Limited and the company. The whole was intended to be and was put at the disposal of X Limited regardless of whether that would result in the said current account going into debit as it actually did with the second tranche.

We find that, consistent with the above intention, the term loan was so structured as to permit the funds to be transferred in toto without tying the availability or the use of the loan to specific invoiced debts.

We find that the borrowing was calculated to enable the company to transfer to or place with X Limited substantially more funds than were required to meet its liabilities to the parent company. The company's ability to sustain such a state of affairs over a period of two years was underpinned by the continued borrowing.

We find that the capital base of the company was itself intended to be and was underpinned and strengthened by the borrowing. In short, we find that the borrowing was for the purpose, and the loan was in the nature, of capital accretion. This was so irrespective of whether it was also intended to strengthen the company's ability to sustain the state of affairs as aforesaid.

The burden of proof is on the company to show that the expenditure incurred was of a revenue nature deductible under section 16(1). That burden, we find, has not been discharged. Indeed, the evidence shows the contrary and we so find. The appeal is therefore dismissed and the relevant assessments are confirmed.