Hong Kong Tax Alert

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Whether and when a debt can be considered bad for tax deduction purposes

A recent decision of the Court of First Instance (CFI) concerns the Commissioner of Inland Revenue (CIR) seeking to appeal against a tax tribunal's decision that a taxpayer could claim a tax deduction in respect of a provision for bad debts, even though the taxpayer had not taken any legal action to recover the debts[1].

The case indicates that in determining whether a debt is bad or irrecoverable, the applicable test is what a reasonable and prudent businessperson, based on the facts and circumstances of a case and on the balance of probabilities, would have concluded.

As such, there may be cases in which a reasonable and prudent businessman can readily conclude, without incurring the expenses inherent in suing a debtor, that a debt is unlikely to be recovered. In short, the law does not require taxpayers to throw good money after bad.

In this case, the CFI refused to grant leave to the CIR for the appeal, dismissing most of the CIR's grounds of appeal as not actually involving a point of law.

Nonetheless, the case highlights that the evidence and arguments involving the deductibility of bad debts can often turn out to be very technical and complicated. Taxpayers should seek professional tax advice where necessary.

This alert concerns the decision in the case and discusses the relevant issues.

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1. Commissioner of Inland Revenue v Right Margin Limited (HCIA 4/2016)

Facts of the case

Victory World Limited (VWL), a joint venture company established by five property developers in around 1993, was engaged in a residential development in Kowloon. Chime Corporation Limited (Chime), a company of the Chinachem Group, as one of the five property developers, held a 10% shareholding in VWL.

The terms of the joint venture were subsequently formally drawn up in a joint venture agreement (JVA) in May 1996. In relation to financing, the JVA specified that:

(i) to the extent the residential development cannot be financed by bank loans and other external liabilities, the five joint venture partners agreed to lend money to VWL by way of shareholders' loans in proportion to their respective shareholdings in VWL;

(ii) such shareholders' loans shall be (a) unsecured and bear interest at a flat rate to be determined by the Board of VWL and (b) not subject to repayment as to principal or interest in whole or in part unless otherwise resolved by the Board except in the event of liquidation of VWL at which time all outstanding principal and accrued interest shall become immediately due and payable; and

(iii) after repaying all bank loans and other external liabilities, the sale proceeds of the residential development shall be applied (a) in repayment of the principal of the shareholders' loans first and (b) then in repayment of the accrued interest on the shareholders' loans.

Shareholders' financing was duly provided to VWL by the five developers and, in the case of Chime, in the form of loans from the taxpayer (the Taxpayer), which was a wholly owned subsidiary of Chime. The principal business activity of the Taxpayer was money-lending, earning interest as income. Interest charged by the Taxpayer was reported as its income on an accrual basis, profits tax being charged and paid by the Taxpayer on this interest income, even though, according to the terms of the JVA, interest had not actually been received by the Taxpayer.

Up to June 1999, VWL had made certain repayments to the Taxpayer. The repayments were agreed by VWL and all the joint venture partners to be repayments of principal only, and not accrued interest.

As at 30 June 1999, after the aforesaid repayments, VWL still owed the Taxpayer approximately HK$399 million. By then, VWL had already sold the bulk of the units in the residential development at a very substantial loss. VWL had no other business apart from the residential development. The value of VWL's remaining assets were less than the amount outstanding and owed to the Taxpayer and the other four joint venture partners who had also provided shareholders' loans.

Based on a value of VWL's net assets as at 30 June 1999 (excluding the shareholders' loans) in the sum of about HK$1.79 billion, the Taxpayer estimated that it could expect to receive 10% thereof, i.e. HK$179 million. Based on such estimation, the Taxpayer made a provision for bad debts of HK$220 million for the year ended 30 June 1999 (i.e., the HK$399 million owed less the HK$179 million expected to be recoverable). Of the provision of HK$220 million as at 30 June 1999, an amount of HK$156 million related to accrued interest due to the Taxpayer, whilst HK$64 million related to the remaining principal of the shareholder's loans due to the Taxpayer.

The Deputy CIR disallowed the Taxpayer's claim for a tax deduction of the provision of HK$220 million in its entirety. The disallowances was apparently on the grounds that the Taxpayer had not established to the satisfaction of the assessor that the debts were bad as at 30 June 1999.

Upon the Taxpayer appealing to the tax tribunal of the Board of Review (BOR), the appeal narrowed to focus on the provision as regards the unpaid accrued interest of HK$156 million. In so doing, the Taxpayer apparently conceded at the BOR that the provision which related to the outstanding shareholder's loan principal of HK$64 million was not tax deductible.

Upon the BOR finding in favor of the Taxpayer in respect of the provision to the extent of the unpaid accrued interest of HK$156 million, the CIR sought leave to appeal from the CFI against the decision of the BOR.

It should be noted that an appeal against a BOR's decision to the CFI can only be made on a point of law but not on a point of fact, the BOR's findings of fact being final.

Decision of the CFI in respect of the CIR's application for leave to appeal

The law

Under section 16(1)(d) of the Inland Revenue Ordinance (IRO), a tax deduction is allowed for "bad debts incurred in any trade, business or profession, proved to the satisfaction of the assessor to have become bad during the basis period for the year of assessment… provided that (i)… deductions under this paragraph shall be limited to [a] debts which were included as a trading receipt in ascertaining the profits, in respect of which the person claiming the deduction is chargeable to tax, of the period within which they arose, and [b] debts in respect of money lent, in the ordinary course of the business of the lending of money within Hong Kong, by a person who carries on that business."

The legal basis on which Taxpayer pursued its claim at the BOR

Given that the loans made by the Taxpayer to VWL were not repayable as to the principal and interest unless the board of VWL resolved otherwise, or only upon the liquidation of VWL, it could possibly be said that the loans by the Taxpayer to VWL were not made in the ordinary course of the business of the lending of money by the Taxpayer (albeit its principal business activity was money lending).

As such, the provision to the extent of HK$64 million which related to the principal of the loans made by the Taxpayer to VWL would probably not qualify for a tax deduction under condition [b] of proviso (i) to section 16(1)(d) of the IRO denoted above.

It was apparently on this basis that the Taxpayer only pursued at the BOR its claim for a tax deduction in respect of the provision to the extent of HK$156 million which related to the unpaid accrued interest on the shareholder's loans as at 30 June 1999.

Given that such interest had previously been treated on an accrual basis as taxable trading receipts of the Taxpayer, a provision for bad debt in respect of the accrued interest should arguably be tax deductible under condition [a] of proviso (i) to section 16(1)(d) of the IRO denoted above.

The legal test for determining whether a debt was bad

At the CFI, Counsel for the CIR accepted that the test of whether a debt was bad or irrecoverable was whether a reasonable and prudent businessperson would have concluded that, on the balance of probabilities, the debt was unlikely to be recovered. The case of *Graham v Commissioner of Inland Revenue (1995) 17 NZTC 12,107 at 12,110* was cited as authority for that proposition.

Counsel for the CIR however argued that the BOR was wrong in law in concluding that the Taxpayer had discharged its burden of proof as regards demonstrating that the provision in respect of the accrued interest of HK156 million was a doubtful debt estimated to the satisfaction of the assessor to have become bad during the year ended 30 June 1999. This was particularly the case given that, after making the total provision of HK$220 million, a further loan of HK$200,000 was subsequently lent by the Taxpayer to VWL in February 2002.

The CFI rejected the Counsel's argument noting that no point of law was actually involved in this ground of appeal. The CFI noted that the BOR had not ignored the grant of the further loan of HK$200,000, but had accepted the unchallenged evidence of the Taxpayer as to how the further loan was granted, which was not inconsistent with the Taxpayer's view taken earlier that part of the money outstanding would probably not be recovered.

The CFI further noted that in general attacks on findings of fact only raise questions of law in very limited circumstances, such as where it is said there is no evidence at all to support the finding. The extent to which a particular piece of evidence should be accepted or rejected, and the weight to be given to the same, are matters for the BOR and not the Courts.

Legal recovery actions may not necessarily have to be taken before a provision for bad debt is admissible

Relying on two other specific facts, Counsel for the CIR further argued that the Taxpayer had not proved to the satisfaction of the assessor that the debts were bad as at 30 June 1999. These two specific facts were: (i) the Taxpayer had never sued VWL nor taken any enforceable step to recover the debts and (ii) the notes to the accounts of VWL for the year ended 30 June 1999 stated that the accounts had been prepared on a going concern basis because the shareholders had agreed to provide adequate funds for VWL to meet its liabilities as they fell due.

The CFI was however of the view that there was no general proposition of law that before a provision for bad debt can be recognized, the taxpayer concerned must have taken active legal steps to recover the debt and failed. The CFI considered that there may be cases in which a reasonable and prudent businessman can readily conclude, without incurring the expenses inherent in suing a debtor, that a debt is unlikely to be recovered. In short, the law does not require taxpayers to throw good money after bad.

The CFI noted that the BOR had taken such a reasonable and prudent businessman approach in concluding that the debts were bad and that there was evidence for the BOR to accept that, based on the net asset value of VWL as at 30 June 1999, the Taxpayer was unlikely to recover HK$220 million out of the total amount of HK$399 million owed by VWL.

As regards the shareholders' undertaking to financially support VWL as disclosed in the notes to the accounts, the CFI considered that there was also evidential basis on which the BOR found that the undertaking was not legally enforceable for lack of good consideration or due to its uncertain effect (e.g. as to whether the undertaking was given to the auditors only rather than to VWL).

As such, the CFI also rejected Counsel for the CIR's argument as not actually involving a point of law.

Whether earlier repayments were for repayments of principal or accrued interest?

Counsel for the CIR also challenged the BOR's finding that the earlier repayments were all for the repayments of principal, and not accrued interest on the shareholder's loans. If this argument prevailed, most of the total provision for bad debts of HK$220 million would not then relate to the unpaid accrued interest but rather to the outstanding principal. As such, based on the Taxpayer's admission at the BOR, most of the total provision of HK$220 million would not then be tax deductible.

The CFI however dismissed this Counsel's argument as having no prospect of success, given the unchallenged evidence before the BOR that the shareholder's loans made by the Taxpayer to VWL were governed by the relevant terms of the JVA.

Whether the two conditions stated in proviso (i) to section 16(1)(d) should be read conjunctively and cumulatively or separately?

In addition to attacking the BOR's finding of facts as having no evidential basis at all as discussed above (thus potentially involving a point of law and thereby appealable), Counsel for the CIR also raised a new point of law, apparently not mounted when the case was heard at the BOR.

Counsel argued that conditions [a] and [b] contained in proviso (i) to section 16(1)(d) of the IRO as denoted above should be read conjunctively and cumulatively so that to be deductible the Taxpayer must show that the debts had both been included previously as taxable trading receipts and also lent in the ordinary course of the business of the lending of money.

However, the CFI flatly rejected this Counsel's argument, considering that, on the plain and ordinary meaning of the words in the proviso, debts covered either under condition [a] or condition [b] of proviso (i) to section 16(1)(d) were tax deductible.

After dismissing Counsel's above grounds of appeal (and also other minor grounds of appeal not discussed here), the CFI refused to grant the CIR leave to appeal.

Commentary

The case indicates that when considering whether a debt is bad or irrecoverable, the applicable test is what a reasonable and prudent businessperson, based on the facts and circumstances of a case and on the balance of probabilities, would have concluded.

As such, in order for a debt to be considered as bad, it may not be necessary for legal recovery actions to be taken. As noted by the CFI in this case, there may be instances where a reasonable and prudent businessman can readily conclude, without incurring the expenses inherent in suing a debtor, that a debt is unlikely to be recovered. In short, the law does not require taxpayers to throw good money after bad.

That said, the evidence and arguments involved in cases of this nature can often turn out to be very technical and complicated. Such technicality can be seen in the arguments of this case involving the nature of earlier repayments and whether those repayments were of principal rather than accrued interest, and whether the undertaking given by the shareholders to financially support VWL as disclosed in the notes to the accounts was a good promise enforceable in law. Taxpayers should seek professional tax advice where necessary.

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