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

There may be cases in which a reasonable and prudent businessperson can readily conclude, without incurring the expenses inherent in suing a debtor, that a debt is unlikely to be recovered, writes **Patrick Kwong** and **Kathy Kun**

Facts of the case

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

The five developers provided shareholders' financing to VWL under a joint venture agreement (JVA). The JVA specified that both principal and accrued interest on the shareholders' loans were not payable unless the Board of VWL resolved otherwise, or upon the liquidation of VWL. Furthermore, any repayment of the shareholders' loans would first be applied to repay principal and then accrued interest.

In the case of Chime, the shareholder's loans were made to VWL through its wholly owned subsidiary (the taxpayer). 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, the interest had not actually been received by the taxpayer.

As at 30 June 1999, after receiving various previous 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.

VWL's net assets as at 30 June 1999 (excluding the shareholders' loans) were estimated to be worth approximately HK$1.79 billion. The taxpayer further estimated that it could expect to receive only 10 percent thereof, i.e. HK$179 million. Based on these estimates, 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, HK$156 million related to accrued interest due the taxpayer, while HK$64 million related to the outstanding principal of the shareholder's loans due the taxpayer.

The Deputy Commissioner of Inland Revenue (CIR) disallowed the taxpayer's claim for a tax deduction of the provision of HK$220 million in its entirety.

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 favour of the taxpayer in respect of the provision to the extent of the unpaid accrued interest of HK$156 million, the CIR sought leave from the Court of First Instance (CFI) to appeal.

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 argued 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 the taxpayer's principal business activity was money lending).

As such, that portion of the provision which related to the outstanding principal of the loans owed by the taxpayer to VWL (i.e. HK$64 million) would probably not qualify for a tax deduction under condition (b) of proviso (i) to section 16(1)(d) of the IRO.

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 the 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.

Whether taxpayer had proved that the debts were bad

Primarily relying on three specific facts, Counsel for the CIR argued that the taxpayer had not proved to the satisfaction of the assessor that the debts were bad as at 30 June 1999. These three specific facts were: (i) subsequent to making the provision of HK$220 million as at 30 June 1999, a further loan of HK$200,000 was granted by the taxpayer to VWL in 2002; (ii) the taxpayer had never sued VWL nor taken any enforceable step to recover the debts; and (iii) 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 however rejected the Counsel's argument as not involving a point of law, considering that the BOR had evidence based on which its finding of fact on this point was made. 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 also 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 case of Graham v. Commissioner of Inland Revenue (1995) 17 NZTC 12,107 at 12,110 was cited as authority for that proposition.

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 HK220 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).

Whether both the two conditions stated in proviso (i) to section 16(1)(d) of the IRO need to be satisfied?

In addition to attacking the BOR's finding of facts as having no evidential basis 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 detailed above should be read conjunctively and cumulatively. As such, a taxpayer must show that 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 in order to successfully claim a deduction.

However, the CFI flatly rejected the 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), 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 would have concluded, based on the facts and circumstances of a case and on the balance of probabilities.

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 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, and whether both conditions stated in proviso (i) to section 16(1)(d) need to be satisfied before a tax deduction for bad debts can be claimed. Taxpayers should seek professional tax advice where necessary.

Patrick Kwong is Tax Executive Director and **Kathy Kun** is Tax Senior Manager of EY Hong Kong.