Privy Council Appeal No. 40 of 1996

Wharf Properties Limited *Appellant*

v.

Commissioner of Inland Revenue *Respondent*

FROM

THE COURT OF APPEAL OF HONG KONG

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL.
Delivered the 27th January 1997

Present at the hearing:-

Lord Browne-Wilkinson
Lord Lloyd of Berwick
Lord Nicholls of Birkenhead
Lord Steyn
Lord Hoffmann

*[Delivered by **Lord Hoffmann**]*

Wharf Properties Limited ("Wharf") is a property development company. In 1987 it decided to acquire and redevelop the old tramway depot at Causeway Bay. By a contract dated 3rd August 1987 it agreed to buy the depot for HK$3,039,000,000. Part of the price was paid at the time of contract and the rest on two dates in 1988. The tramway company vacated the premises on 20th March 1989. Wharf then redeveloped the site as a commercial complex known as Times Square.

Wharf obtained the purchase money by borrowing from various banks and financial institutions. The loans were for short periods, ranging from a week to a month, but were always renewed. In the year to 31st March 1988 the interest paid on these loans was $51,275,848; in the year to 31st March 1989, $292,000,841. During the same two years Wharf received licence fees from the tramway company amounting in total to $15,151,613.

The question in this appeal is whether Wharf is entitled to deduct the interest payments for the purpose of calculating its taxable profits. Section 16(1) of the Inland Revenue Ordinance provides that in ascertaining the taxable profits of any person:-

> "... there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period, including -
>
> (a) where the conditions set out in subsection (2) are satisfied, sums payable by such person by way of interest upon any money borrowed by him for the purpose of producing such profits ..."

It is not necessary to refer to the conditions in subsection (2) (which are mainly concerned to ensure that, with specified exceptions, interest will not be deductible unless it is taxable in the hands of the recipient) because there is no dispute that they were satisfied. The Commissioner did however contend in the High Court and the Court of Appeal that the interest payments did not come within section 16 at all. He said that they had not been incurred for the production of taxable profits because Wharf did not need to borrow the money and the real purpose of the loans was to enable Wharf to make advances to associated companies for investment overseas. This argument was rejected by Patrick Chan J. [1995] 1 H.K.L.R. 347 and the Court of Appeal [1995] 2 H.K.L.R. 552. Although it was raised again in the Commissioner's printed case, their Lordships indicated that in accordance with their usual practice they were unwilling to interfere with concurrent findings of fact and Mr. McCall Q.C., who appeared for the Commissioner, did not advance any argument on this point.

Prima facie, therefore, the interest was deductible under section 16(1)(a). It was incurred for the purpose of earning taxable profits in future years: compare *Commissioner of Inland Revenue v. Swire Pacific Limited* [1979] 1 H.K.T.C. 1145. But section 17 contains a list of various kinds of expenditure in respect of which "no deduction shall be allowed". Their Lordships think that in the absence of express contrary language, expenditure which comes within section 16 will not be deductible if it falls within one of the prohibited categories in section 17. Since sections 16 and 17 together "provide exhaustively for the deduction side of the account which is to yield the assessable profits" (*Commissioner of Inland Revenue v. Mutual Investment Co. Ltd.* [1967] A.C. 587, 598), section 17 would serve no purpose if it did not exclude deductions which would otherwise be allowed under section 16. Some of the heads of deduction in section 16 expressly say that

they are to apply notwithstanding anything in section 17, but subsection 16(1)(a) is not one of them.

The relevant head of prohibition in section 17 is subsection 1(c): there shall be no deduction of "any expenditure of a capital nature". The question therefore is whether the interest payments were expenditure of a capital nature. In thus adopting a criterion of deductibility which refers to the "nature" of the payment - either capital or revenue - the statute is adopting an accounting concept as a rule of law: see Dixon J. in *Hallstroms Pty. Ltd. v. Federal Commissioner of Taxation* (1946) 72 C.L.R. 634, 646. But whereas the application of the concept by accountants is often a debatable question on which professional opinions may differ, the law is obliged to give a decisive answer. Expenditure is either of a capital nature or it is not, and whether it is one or the other is a question of law: see *Beauchamp v. F.W. Woolworth Plc* [1990] 1 A.C. 478 and the cases cited by Lord Templeman at pages 491-2.

There are many cases in which different forms of words have been used to try to illuminate the distinction in terms appropriate to the particular and often complicated facts of the case. But the present case seems to their Lordships to be relatively straightforward, in which it is sufficient to say that the cost of "creating, acquiring or enlarging the permanent ... structure of which the income is to be the produce or fruit" is of a capital nature, while "the cost of earning that income itself or performing the income-earning operations" is a revenue expense: see Viscount Radcliffe in *Commissioner of Taxes v. Nchanga Consolidated Copper Mines Ltd.* [1964] A.C. 948, 960. Applying this distinction, it seems to their Lordships to be plain that the payments of interest during the years in question were made for a capital purpose, namely, as consideration for the use of the money which enabled Wharf to acquire the tramway depot and hold it pending its conversion by redevelopment into an income-earning capital asset.

The simplicity of this answer is only slightly complicated by the fact that during the years in question the property also yielded some income in the form of licence fees from the tramway company. But earning this income was not the purpose for which Wharf acquired the depot, borrowed the money or paid the interest. It was an adventitious benefit unconnected with its larger ambitions. Their Lordships think that the justice of the case was more than adequately met by the Commissioner treating it as a subsidiary purpose and allowing a deduction of the equivalent amount of interest.

Mr. Gardiner made no point of the tramway licence fees but did advance several other arguments against the conclusion that the interest payments were expenses of a capital nature. First, he said that interest was by definition a revenue payment and could not be anything else. Their Lordships think that this confuses the position of payer and recipient. It is true that in the hands of the recipient, interest will be either the earnings of capital advanced or, in some cases, additional income derived from trading in money. In either case, it will have the character of income. From the point of view of the payer, however, a payment of interest may be a capital or revenue expense, depending upon the purpose for which it was paid. The fact that it is income in the hands of the recipient and a recurring and periodic payment does not necessarily mean that it must be a revenue expense. Wages and rent are income in the hands of their recipients; periodic payments, in return for services or the use of land or chattels respectively. But whether such payments are of a capital or revenue nature depends on their purpose. The wages of an electrician employed in the construction of a building by an owner who intends to retain the building as a capital investment are part of its capital cost. The wages of the same electrician employed by a construction company, or by the building owner in maintaining the building when it is completed and let, are a revenue expense.

For this purpose, their Lordships consider that there is no material distinction between interest and other periodic payments. As Lord Upjohn said in *Chancery Lane Safe Deposit and Offices Co. Ltd. v. Inland Revenue Commissioners* [1966] A.C. 85, 124 (in a passage quoted by the Commissioner in his correct and succinct reasons for disallowing the deduction): "the cost of hiring money to rebuild a house is just as much a capital cost as the cost of hiring labour to do the rebuilding".

Mr. Gardiner said that it was not legitimate to examine the purpose for which the money was borrowed in order to ascertain whether the interest paid in consideration of the borrowing had been for a capital or revenue purpose. Their Lordships agree with Litton V.-P. that, on the contrary, there is no other way in which the nature of the interest payment can be discovered. The immediate consideration for each payment of interest is, of course, the use of money during the period in respect of which the interest has been paid, but since money is no more than a medium of exchange which may be expended for either capital or revenue purposes, the question can be answered only by ascertaining the purpose for which the loan was required during the relevant period.

Mr. Gardiner insisted however that the decision of the House of Lords in *Beauchamp v. F.W. Woolworth Plc* [1990] 1 A.C. 478 made it impossible for their Lordships to adopt such a course. In that case the question was whether a currency exchange loss on two borrowings, each of 50 million Swiss francs for periods of five years, was "in respect of any sum employed or intended to be employed as capital in the trade" within the meaning of section 130(f) of the (UK) Income and Corporation Taxes Act 1970. Lord Templeman said at page 493:-

> "A trading company which borrows unconditionally a fixed amount for a definite period may use the money generally for the purposes of its business or for any other purpose authorised by its constitution, and even when the money is employed in the business, the money may be laid out on income expenditure or capital expenditure ... For my part, I do not attach any importance in the present circumstances to the intentions of the taxpayer or to the actual use made of the money in the present circumstances. The 100 million Swiss francs, worth some £10m., were available to the taxpayer as additional capital."

This decision does not seem to their Lordships to help Mr. Gardiner at all. It is directed to a different question, namely whether the sum borrowed constitutes an addition to the company's capital or is a revenue *receipt*. In other words, it looks at the nature of the *loan* in the hands of the recipient rather than the question of whether a payment of interest is a capital or revenue expense. It is unusual for a loan of money to constitute a revenue receipt but this can be the case if borrowing money is "part of the ordinary day to day incidence of carrying on the business" (Lord Templeman in *Beauchamp* at page 497) which may be the case in businesses of banking, financing or otherwise dealing in money: see *Scottish North American Trust Ltd. v. Farmer* [1912] A.C. 118. Ordinarily, however, a loan to a trading company, whatever the purpose for which it is intended to be used, will be an addition to that company's capital. Mr. Gardiner did submit that the shortness of the successive terms of the loans in this case was enough to make them revenue receipts, but their Lordships do not agree. The borrowing did not form part of the company's trading activities. While it or a replacement loan remained in place it was an addition to Wharf's capital: compare *European Investment Trust Co. Ltd. v. Jackson* (1932) 18 T.C. 1.

Thus, while the question of whether money is intended to be used for a capital or revenue purpose is inconclusive as to whether its receipt is a revenue receipt or an addition to the company's capital, the purpose of the loan during the period for which the interest payment was made is critical to whether it

counts as a capital or revenue expense. In the present case, during the whole of the two years in question, the loan was clearly being applied for the purpose of acquiring and creating a capital asset rather than holding it as an income-producing investment. It follows that the interest was being expended for a capital purpose.

Mr. Gardiner relied also upon the equivocal nature of the accounting evidence. Patrick Chan J. found that there was no standard accounting practice on the capitalisation of interest. There were arguments in favour of treating all costs of borrowing as a charge on income; in particular, the fact that it may be arbitrary to attribute borrowing costs with the application of the borrowed funds to a particular asset. The relevant Guideline issued by the Hong Kong Society of Accountants accepted that different views were possible. But the overriding requirement in accounts, towards which guidelines and standards are intended only to provide assistance, is to give a true and fair view of the company's financial affairs. In this case it is accepted that the interest was paid in respect of loans specifically earmarked for the tramway depot development; this, indeed, was the basis upon which the taxpayer repelled the Commissioner's case that the true purpose of the loans was to enable other group companies to invest overseas. It may be that the present case is unusual in the precision with which the purpose of the loan can be identified. In cases like *Beauchamp v. F.W. Woolworth Plc* [1990] 1 A.C. 478, where the borrowings are for the general purposes of the company and are spent on both capital and revenue account, it will be much more difficult to say whether a given interest payment is an expenditure of a capital or revenue nature. But this question did not arise in the *Beauchamp* case and there is no such difficulty in this one. Their Lordships think that in the present case a true and fair view of the taxpayer's transactions required the interest to be treated as an expense of the development.

It remains only for their Lordships to make certain observations upon the judgments in the Court of Appeal and some of the authorities to which they were referred. Their Lordships are entirely in agreement with the judgment of Litton V.-P. ibid 554-564, and in particular his observation at page 562 that to say that the interest payments secured the use of the bank's money was unhelpful; it is necessary to inquire into the purpose of the loan. They do not share the doubts of Godfrey J.A. at page 564, over whether "on a strict construction" interest on moneys borrowed can ever be expenditure of a capital nature. It seems to their Lordships that there are cases, of which this is one, when it plainly is. Nor do they agree with Ching J.A. at page 566 that this decision logically entails that interest paid on a loan to acquire a capital asset will always be capital expenditure. Each payment of interest must be considered in relation to the purpose of the

loan during the period for which the interest was paid. Once the asset has been acquired or created and is producing income, the interest is part of the cost of generating that income and therefore a revenue expense. In this respect their Lordships agree with the judgment of McMullin J. in *Tai On Machinery Works Ltd. v. C.I.R.* [1969] 1 H.K.T.C. 411 and are unable to follow the reasoning by which the National Court of Papua New Guinea arrived at a contrary conclusion in *Travelodge Papua New Guinea Ltd. v. Chief Collector of Taxes* (1985) 85 A.T.C. 4432.

Their Lordships will accordingly humbly advise Her Majesty that the appeal should be dismissed. The appellant must pay the Commissioner's costs before their Lordships' Board.