

Lending Traps

BY CURTIS H.L. WONG CPA, LLB, PCLL

Banking mortgage deed could be misleading and be incorporated with other guarantee terms

Financing your business by borrowing money is of great concern in every business. Do you understand what is "all monies legal charges"? Have you really read the mortgage deed drafted by banks or their lawyers before signing? Or, you will solely rely on what the bankers or the lawyers explained to you.

In the application of general facilities granted to the company, the bank used to ask the directors or shareholders to have property pledged. In many cases, properties provided as security may come from a close relative or friend who does not have any involvement in the company's business. Most people wrongly believed that at the most, worst came to worst, the person provided the property as security would lose his property and there would be no other responsibilities. However, this person is in fact acting as a "surety" for the general facilities granted to the company.

A surety is a person who agrees to answer the debt or obligation of another (i.e. the principal debtor – the company) to a third party (i.e. the bank). In general term,

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acting as a surety may be equivalent to acting as a guarantor. However, a guarantor can be distinguished from a surety in that the surety's liability is joint and primary with the principal debtor and whereas the guarantor's liability is only secondary - his liability to pay arising after the default of the principal debtor. Nevertheless, the terms "suretyship" and "guaranty" are often used interchangeably in the business world.

In Hong Kong, mortgage of property takes the form of legal charge. It makes ordinary people difficult to understand the technical documentation in borrowing process. The contract of suretyship may be constituted by a charge on property with or without any personal liability. Most banks in Hong Kong require a legal charge by a surety also to give a personal guarantee for all monies outstanding.

The lawyers arranging the lending documents are usually instructed by the bank and to act for it, the borrower and the mortgagee. The personal guarantee provision may be hidden inside the borrowing deed titled as a legal charge. In effect, the true meaning effect of the borrowing deed might not be well known to the borrower and the surety. With the personal guarantee provision, the unlimited liability or unlimited amount is no longer restricted on the property only. The final effect is that the surety who provided the property for the general banking facilities is exposed to unlimited personal guarantee or liability.

In the recent case, *Wing Hang Bank Limited v. Kwok Lai Sim and others* (HCMP 4362/2003; 28 February 2008), the sisters are joint tenants of the mortgaged property and lived there with their mother. Their brother (W) operated a company which was in financial difficulties. W approached the Bank for a general banking facility. After negotiation, the Bank agreed to extend the general banking facilities to HK\$2.7 million and required the sisters' property as security. The property was valued at HK\$1.85 million by the Bank. The mortgage deed was named as a "Legal Charge" on the Property for All Monies. In fact, it included a personal guarantee provision for all monies due and owing to the Bank by W's company.

Shortly after the Legal Charge was executed, the Bank demanded the sisters to personally pay about HK\$2.6 million and tried to enforce the mortgage against the sisters. The lawyer handling the lending documents was instructed by the Bank and to act for it, the borrower (W's company) and the sisters.

After hearing, the court found that (a) both the Bank and the lawyer had misrepresented to the sisters and had given them the wrong impression that their liability would only be limited to the property only; (b) the confusing stage of the documents and the content therein, together with both



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the Bank and the lawyer failing to observe the guidelines and directions given by the Hong Kong Association of Banks and the Law Society had the effect of misleading the sureties; and (c) in the end the sisters probably would not know the true meanings and effects of the Legal Charge. The sisters eventually succeeded in defending the action against the Bank.

The sisters in the case were lucky. Should the Bank or the lawyer observe the required guidelines or directions, or the sisters were given sufficient opportunities for seeking independent legal advice, the result might be otherwise.

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Tax: Commission Expenses

BY ANNIE K.Y. CHEUNG ARA & ASSOCIATES CERTIFIED PUBLIC ACCOUNTANTS

Commissions, rebates and discounts incurred are required to comply with the disclosure requirements prescribed by the Inland Revenue Department for tax deduction. Unless those payments (1) are allowed in the ordinary course of trade on a principal to principal basis; or (2) are paid to one (including an employee) whose name, address and the amount paid are reported on the statutory employer's return, the following information must be disclosed on filing profits tax returns:

- (a) the gross amounts which clearly identify the payment of commissions, rebates and discounts in the accounts and tax computations;
- (b) full name, address and identity card number or business registration number of the recipient;
- (c) whether the recipient has any relationship with the taxpayer;
- (d) amount of the payment; and
- (e) details of services rendered; and, where necessary, evidence of payment.

Where the taxpayer is unable or unwilling to disclose the prescribed details, the amounts paid will be disallowed in the tax computations. If the payer suffers an overall operating loss in the relevant period or the payment is of capital nature, the IRD may have to raise direct assessments on the recipients and the payer may be assessed as agent of the recipients of commissions.

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UPDATE

The Second Protocol to the Arrangement for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with respect to Taxes on Income with the Mainland.

This Second Protocol which was signed on 30 January 2008 has made some amendments to the Arrangement signed on 21 August 2006 and entered into force on 8 December 2006. Under the Second Protocol:

(a) In determining whether a Hong Kong enterprise providing services, including consulting services, in the Mainland is liable to the Enterprise Income Tax, "183 days" is adopted for "six months" as the basis of calculation.

This means that Hong Kong enterprises would be considered as having a permanent establishment on the Mainland and be chargeable to tax if they provide services for an aggregate of 183 days in any 12-month period on the Mainland. (This clarified the previous different interpretations on meaning of "month".)

(2) Generally, the gains derived by a Hong Kong resident from the alienation of immovable assets should be taxable in Hong Kong only.

However, the gains derived by a Hong Kong resident from the alienation of shares in a Mainland company may be taxed on the Mainland, if this company once owned at least 50% of immovable properties within three years prior to the alienation transaction.

Further, the gains derived by a Hong Kong resident from the alienation of shares in a Mainland company may be taxed on the Mainland, if within 12 months prior to the alienation transaction the vendor once owned not less than 25% of the entire shareholding of this Mainland company.

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