香 港 會 計 師 公 會
HONG KONG SOCIETY OF ACCOUNTANTS
(Incorporated by the Professional Accountants Ordinance, Cap. 50)
香 港 金 鐘 道 八 十 九 號 力 寶 中 心 二 座 四 樓
4th Floor, Tower Two, Lippo Centre, 89 Queensway, Hong Kong.
Tel: 2287 7228 Fax: 2865 6603 / 2865 6776 Website: http://www.hksa.org.hk E-mail: hksa@hksa.org.hk

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Commissioner of Inland Revenue,
Inland Revenue Department
36/F, Revenue Tower
5 Gloucester Road
Wanchai,
Hong Kong

Dear Madam,

Draft DIPN on Profits Tax: Prepaid or Deferred Revenue Expenses

Background

After the decision of the Court of Final Appeal (CFA) in the case of *CIR v Secan Limited & Ranon Limited* 5 HKTC 266 (*Secan*), the Inland Revenue Department (IRD) reviewed its position in relation to "prepayments" i.e. amounts which are in the nature of revenue expenditure in a particular year, but in accordance with the accounting concept of matching revenue with expenditure are carried forward and charged to the profit and loss account in the period in which the related profits are received (e.g. prepayments of rent, insurance premiums and interest). According to the Draft DIPN on Profits Tax: Prepaid or Deferred Revenue Expenses (Draft DIPN), the IRD's revised position is that no deduction can be claimed in a taxpayer's Profits Tax computation in respect of the whole amount (rather than the portion amortised) which, although incurred in the basis period under consideration, has not in effect been charged against the taxpayer's accounting profits for that period, because it relates to a future period (e.g. where the amount has been added to a current asset account in the balance sheet of the business, with the intention that it will be amortised in subsequent periods by charging to the profit and loss account the part of the expenditure that relates to each such period).

The Society would like to express its comments on the Draft DIPN in the paragraphs below.

The *Secan* case

In the *Secan* case, the central issue facing the CFA was whether the Inland Revenue Ordinance (IRO) prohibited the capitalisation of interest for the purpose of computing the taxpayer's assessable profits and allowable losses.

The taxpayer, a group of companies engaged in the business of property development, began to make sales of completed flats in its fourth year of trading. It sought to capitalize the interest charges incurred in the first three years of trading by treating them as part of the cost of development in the same way as it treated the cost of the site and the construction costs. By charging the interest to the development cost account, the taxpayer purported to prevent the increased value of property under development from creating a trading profit to be carried into the profit and loss account, whilst charging the amount to the profit and loss account in order to increase the loss for the years concerned. Such losses were described by the CFA as fictitious losses arising from double counting. Prior to its fourth year of trading, whilst the taxpayer made no claim to deduct interest or to carry forward losses in excess of those shown in its tax computations,

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it paid tax on the profits in the third year after carrying forward the small losses from the two earlier years.

The CFA denied the taxpayer's claim for deducting the whole of the interest charges incurred in the first three years from the sale proceeds of the fourth year.

Application of the *Secan* decision

It is worth noting that, according to the CFA, had the taxpayer in the *Secan* case continued to adopt the same accounting policies as in its first three years of trading, it would have obtained relief for its interest payments by treating them as part of the cost of sales and deducting an appropriate proportion of the total from the proceeds of sales made in the fourth year. Instead the taxpayer elected to rewrite its accounts retrospectively in order to set the whole of the interest charges for the first three years as well as the interest charge in the fourth year against the proceeds of sales made in the fourth year. The case was therefore directly concerned with when and how interest capitalized whilst the trading stock was work in progress would qualify for deduction and was decided on the particular facts of the case.

On the other hand, the CFA in the *Secan* case has not decided upon the issue of the deductibility of prepaid or deferred revenue expenses in general, e.g. prepayment of rent, insurance premiums and interest, which is essentially a matter of timing difference. For example, in *Lo & Lo v CIR* (1982) 2 HKTC 34 (*Lo & Lo*), a case concerning the deductibility of a provision for staff retirement benefits and which was applied in, e.g. *CIR v National Mutual Centre (HK)* Ltd (1998) 4 HKTC 649, the Privy Council held that it was not necessary for an amount to have been actually paid or even due and payable in a particular year for it to be deductible in that year.

The Society therefore has considerable doubts about the appropriateness of seeking to apply the decision in *Secan* to the deductibility of prepaid revenue expenses generally in the way proposed in the Draft DIPN.

Section 16(1) of the Inland Revenue Ordinance

The Privy Council in the *Lo & Lo* case also decided that, subject to any specific statutory qualification, the application of the principles of proper commercial accounting practice in relation to receipts and deductible expenditure is involved in the process of ascertaining assessable profits. In fact, the current practice of allowing deduction of prepaid revenue expenses is permitted under section 16(1) of the IRO.

Section 16(1) of the IRO provides that, "In ascertaining the profits in respect of which a person is chargeable to tax under this Part (IV) for any year of assessment 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*…" [emphasis added]. The wordings of the provision, therefore, expressly permit the deduction of an expense incurred for producing chargeable profits in respect of which tax is chargeable for any period, which may not necessarily be the current period.

Notwithstanding the observations of Lord Millett as referred to in paragraph 10 of the Draft DIPN that section 16 permits outgoings to be deducted only to the extent to which they are incurred in the relevant year and that in this respect there is no difference between the laws of Hong Kong and the law of England, the relevant provisions in the UK Income and Corporate Taxes Act 1988 do not seem to have provided for the deduction of expenses incurred in the current period for producing chargeable profit in respect of which tax is chargeable for any period, as in the case of section 16 of the IRO.

As indicated by the CFA in the *Secan* case, as the taxpayer elected to capitalize interest when preparing its financial statements, its profits and losses must be assessed on the same basis unless prohibited by the IRO. In calculating the assessable profit of its fourth year of trading, the taxpayer's claim for deducting the interest charges incurred in the first three years from the sale proceeds of the fourth year was denied by the CFA. On the particular facts of the case, however, relief would have been available under section 16 of the IRO if the taxpayer continued to adopt the same accounting policies as in its first three years of trading by treating them as part of the cost of sales and deducting an appropriate proportion of the total from the proceeds of sales made in the fourth year.

Whilst the application of the *Secan* decision should be restricted to the particular facts of the case, the revised practice as expressed in the Draft DIPN has departed from the legal position with regard to deductibility of prepaid revenue expenses, e.g. rent, insurance premiums and interest laid down by section 16 of the IRO.

Foreign Corporations

We would suggest that the section of the Draft DIPN dealing with foreign corporations (paragraph 17) is likely to create uncertainty amongst any such corporations that are liable to pay Hong Kong tax. The Draft DIPN gives no clear and definitive statement of how the Department will treat prepayments but indicates only that "consideration will be given" to the application of accounting standards from the "home" jurisdiction, and even then only if detailed information on the relevant standard and its application is provided. The alternative is apparently for such corporations to adjust their accounting profits in accordance with the position that would have obtained had they used Hong Kong accounting standards, which may not be practical for them.

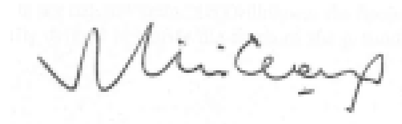
Application of accounting principles

We are also concerned that the Draft DIPN may be interpreted to imply more broadly that, all things being equal, tax treatment and accounting treatment should necessarily coincide with one another. Under the IRO there are for example various types of allowable items, such as those provided for under sections 16A, 16B,16E and 16G, which in accordance with accounting principles are not shown in the profit and loss account. We believe that the strict application of accounting principles in the way suggested by the Draft DIPN would represent a significant change in approach from that adopted in the past.

On a more minor level, we are unclear as to what might be meant by the term "implied provision of the Ordinance" in paragraph 16, and we note that the references in the Draft DIPN to "Lord Millett" have been misprinted as "Lord Millet".

We trust that you will find the above comments to be constructive. If you have any comments and questions in respect of the above, please feel free to contact Mr. Peter Tisman, Deputy Director (Business & Practice) at the Society.

Yours faithfully,



WINNIE C.W. CHEUNG
SENIOR DIRECTOR
PROFESSIONAL & TECHNICAL DEVELOPMENT

PMT/JT/ay