Inland Revenue Department
The Government of the Hong Kong Special Administrative Region
of the People's Republic of China

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 40 (REVISED)

PROFITS TAX

PREPAID OR DEFERRED REVENUE EXPENSES

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the laws as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued in October 2002.

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Commissioner of Inland Revenue

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INTRODUCTION

The purpose of this Practice Note is to outline the views of the Inland Revenue Department ("the Department") in relation to the treatment of "prepaid or deferred revenue expenses (prepayments)" i.e. cash disbursement or incurrence of liabilities which is in the nature of revenue expenditure in a particular year, but in accordance with the accounting concept of matching revenue with expenditure is 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, rate, insurance premium and interest). In the first instance, such expenditure is typically debited to a current asset account in the balance sheet of the business as deferred expenditure, and then amortised in subsequent periods by charging to the profit and loss account the amount of the expenditure that relates to each such period. The Department's position in relation to such prepayments has recently been reviewed in the light of the decision of the Court of Final Appeal in the case of *Commissioner of Inland Revenue v Secan Limited & Ranon Limited 5 HKTC 266* ("*Secan*").

POSITION PRIOR TO SECAN

2. Prior to *Secan*, the Department generally accepted that if an expense would typically have been paid in advance (e.g. car licence fee, insurance premium and subscription fee), the prepayment should be allowed as a deduction on the basis that the expense had been incurred. Obviously, enquiries would usually have been made if the expense involved would not normally have been due for payment in advance and the period was significant. If it was concluded in such a case that an avoidance arrangement was involved, a deduction would have been denied. The Department's position in this regard remains unchanged.

THE SECAN CASE

3. The decision in the case was handed down by the Court of Final Appeal on 8 December 2000. The central question was whether the Inland Revenue Ordinance prohibited the capitalisation of interest for the purpose of computing a taxpayer's assessable profits and allowable losses. The company

concerned was involved in the business of property development. During a number of years (1988 to 1990) whilst a property was under development it incurred substantial interest charges. The company capitalised the interest charges 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. The amounts capitalised were carried to the company's balance sheets by adding them to the value of property under development. For these years the profit and loss accounts of the company contained no entries for the costs of development and interest charges incurred.

4. In 1991 the company began to sell completed flats in Phase I of the development project. In this year it sought to set the whole of the interest charges for the earlier years as well as the interest charge in the current year against the proceeds of sales made in the current year. The taxpayer contended that by failing to deduct interest charges for the earlier years in the years in which they were incurred, its tax computations understated the loss in each of those years. In other words, the taxpayer argued, insofar as the claim related to interest incurred in earlier years, the claim should be understood not as a claim to deduct interest but as a claim to carry forward the understated losses of those years and set them against the profits of the current year.

5. The Commissioner's response was to the effect that the taxpayer's computations and financial statements for the first three years, which were agreed to show a true and fair view of the taxpayer's affairs, were correct; the Ordinance did not prohibit the capitalisation of interest; and the interest was deducted in each of the years in which it was incurred but, because it was capitalised, the deductions did not give rise to any losses capable of being carried forward.

6. To put the matter briefly, the Court agreed with the Commissioner's position in relation to the case under consideration. The importance of the decision, however, lies in its wider ramifications. *Secan* was directly concerned with a trading stock issue, i.e. when and how interest capitalised whilst the trading stock was work in progress would qualify for deduction. The terms of the decision, however, are such that they provide guidance as to the appropriate treatment of other categories of expenditure, including expenditures on prepayments. And in the latter regard, it has now been concluded, following consultation with the Department of Justice, that the Department should revise its practice.

REVISED PRACTICE

7. In essence the Department's revised position in relation to prepaid revenue expenses (i.e. those which are amortised or charged against profits in a subsequent period or periods) is that the tax treatment should follow the accounting treatment of such expenses, provided that the treatment in the accounts is in accordance with the prevailing generally accepted principles of commercial accounting and is not inconsistent with any provision in the Inland Revenue Ordinance. In other words, it will not be accepted that any 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 or periods (e.g. where the amount has been debited 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).

REASONS FOR THE CHANGE

8. As was indicated in the introduction, it was previously common practice to allow a deduction by way of a computational adjustment for the whole amount of a prepaid expense in the year it was incurred. The underlying rationale was that expenditure on a prepayment qualified for deduction under section 16 of the Ordinance as (having been paid) it had been "incurred" and had not otherwise been deducted (as it was not charged to the taxpayer's profit and loss account). *Secan* indicates that this approach was misguided in several respects.

9. The *Secan* decision made it clear that assessable profits must be ascertained in accordance with the ordinary principles of commercial accounting, as modified to conform with the Ordinance. As was stated by Lord Millett NPJ, who delivered the unanimous judgment of the Court, at page 330 –

> "Where the taxpayer's financial statements are correctly drawn in accordance with the ordinary principles of commercial accounting

> and in conformity with the Ordinance, no further modifications are required or permitted."

10. It is also pertinent to refer to the following observations of Lord Millett concerning the purpose of section 16 (at page 331) –

> "… But the profits of a business cannot be ascertained without deducting the expenses and outgoings incurred in making them, and the section is not needed to authorise them to be deducted. Sections 16 and 17 (which disallows certain deductions) are enacted for the protection of the revenue, not the taxpayer, and in my opinion section 16 is to be read in a negative sense. It permits outgoings to be deducted *only* to the extent to which they are incurred in the relevant year. In this respect there is no difference between the law of Hong Kong and the law of England. In both jurisdictions expenses and outgoings are deductible in the year in which they are incurred and not otherwise."

11. On the basis that section 16 should be read in a negative sense and is for the protection of the revenue, it must follow that the section cannot be called upon by a taxpayer to justify a deduction in respect of any item of expenditure where accounts have been correctly prepared; rather it serves to sanction the disallowance of a deduction claim where the criteria in the section are not satisfied.

12. Lord Millett's affirmation that, in so far as "incurrence" of expenditure is concerned, the position in Hong Kong is the same as that in England is noteworthy. In other words, it is proper for Hong Kong to apply the relevant UK authorities on the timing of deductibility of revenue expenditures. One such relevant authority on this subject is *Gallagher v Jones [1993] STC 537*, one of the authorities cited in *Secan*. [The court also considered at the same time the case of *Threlfall v Jones (Inspector of Taxes)*, which raised identical issues of law.] One of the issues in that case was whether, reflecting the accounts of the taxpayer, the whole amount of expenditure incurred by way of rental payments was deductible in the accounting period in which it was incurred, notwithstanding that the expenditure might be for the purpose of securing future benefits. In essence, the position of the Inspector of Taxes was that the loss relief of the taxpayer

should be computed on the basis that the amounts in question should be spread over a longer period. Uncontradicted evidence was given in the course of the case to the effect that the accounts were not in accordance with relevant accounting standards and that they gave a completely misleading picture of the trading results, in that they had the effect of anticipating losses. On appeal from the decision of the Special Commissioner in favour of the Revenue, Harman J found for the taxpayer. He referred to the decisions of the House of Lords in *Vallambrosa Rubber Co Ltd v Farmer* (*Surveyor of Taxes*) *(1910) 5 TC 529* and *Ostime (Inspector of Taxes) v Duple Motor Bodies Ltd 39 TC 537*, and in his concluding summary, said ([1993] STC 199 at 216-217) –

> "In the result, it seems to me that because of the principle I see established by the House unanimously and in clear words in *Duple Motor Bodies* actual expenditure properly incurred and referable to the trade is properly chargeable in the accounts for the year in which it falls due notwithstanding that prudent and proper principles of commercial accounting would draw the commercial accounts of the trading enterprise on a different basis and would spread forward the actual expenditure incurred over future years so as to give a more balanced view of the nature of the success or failure of the trade."

13. In essence, this conclusion was consistent with the basis on which prepayments were previously allowed as deductions in Hong Kong. However, the decision of Harman J did not prevail. On appeal, the Court of Appeal found for the Revenue. Sir Thomas Bingham MR, with whom the other members of the Court agreed, rejected Harman J's interpretation of the *Duple Motors* decision. At page 553, he said –

> "The issue in *Duple Motors* was, as it seems to me, far removed from that in the present case. The question was not whether expenditure should be charged during the year when it is incurred but whether one of two acceptable accountancy principles should be preferred to the other, which the taxpayer company had consistently adopted. I do not question the correctness of the decision; but I do not, with respect, think that for present purposes it will bear the weight which Harman J gave to it."

He went on to conclude, at page 555 –

> "The object is to determine, as accurately as possible, the profits or losses of the taxpayers' businesses for the accounting periods in question. Subject to any express or implied statutory rule, of which there is none here, the ordinary way to ascertain the profits or losses of a business is to apply accepted principles of commercial accountancy. That is the very purpose for which such principles are formulated.
>
> The authorities do not persuade me that there is any rule of law such as that for which the taxpayer contended and the judge found. Indeed, given the plain language of the legislation, I find it hard to understand how any judge-made rule could override the application of a generally accepted rule of commercial accountancy which (a) applied to the situation in question, (b) was not one of two or more rules applicable to the situation in question and (c) was not shown to be inconsistent with the true facts or otherwise inapt to determine the true profits or losses of the business."

14. The decision in the *Gallagher* case is clearly consistent with the view that the taxation treatment of prepayments should follow the recognised accounting treatment. This is reflected in the following extract from the Inspectors Manual of the United Kingdom's Inland Revenue –

> "A deduction may also be sought for expenditure charged to a current asset account in the balance sheet, such as 'prepayments' or 'deferred expenditure'. In such a case it is very doubtful whether the taxpayer can point to any general tax principle which overrides the accounting treatment. In particular, the case of *Threlfall v Jones (66 TC 77)* is authority for the view that there is no general tax principle to the effect that a deduction is available for revenue expenditure when it is incurred or paid. It is extremely unlikely therefore that a deduction can be obtained for the expenditure prior to the period in which it is charged against profits in the accounts.
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> This imposes a discipline for Case I purposes which is a very important feature of the way we compute taxable trading profit. As

a general rule it is not possible for the trader to take a more conservative view for tax than he does for other purposes. So, if a company wishes to reduce its taxable profit it has to tell creditors, shareholders and the stock market the same story."

15. It can be seen that the decision in *Gallagher v Jones* provides for a more liberal construction of the term "incurred", i.e. revenue expenditure can be spread over the accounts of more than one period for tax purposes. In essence, a prepayment can be regarded as incurred in a particular accounting period to the extent that it is amortised or expensed to the profit and loss account for that period, provided that the treatment is in accordance with generally accepted accounting practice.

SUBSEQUENT YEARS

16. Under the revised practice (see paragraph 7 above), the Department will also apply taxation treatment in accordance with established accounting principles in the subsequent year or years when the prepayments are effectively charged against profits as expenses with the passage of time, usage or event. Such a practice is consistent with Lord Millett's affirmation that the position in Hong Kong is no different from that in the UK in terms of deductions and outgoings only being deductible in the year in which they are incurred (see paragraph 10 above) and also with the decision in *Gallagher*, which we can turn to for guidance on the timing of revenue expenditure deductions (see paragraph 12 above).

17. Guidance may also be obtained from the decision of the Privy Council in the case of *Lo & Lo v Commissioner of Inland Revenue 2 HKTC 34*, concerning the deductibility of a provision for staff retirement benefits. The decision confirmed that an amount does not have to be actually paid or even due and payable in a particular year for it to be deductible in that year. The following extract from the judgment of Lord Brightman, delivering the opinion of the Board, is again authority for recognising that deductions can be allowed for taxation purposes on the basis of the applicable accounting treatment –

"It is perfectly correct to say that sections 16 and 17 provide exhaustively for the deductions which are permissible to be made,

> but not in the sense that permitted deductions are confined to the particular matters specified in paragraphs (a) to (h) of section 16(1). Sections 16 and 17 provide exhaustively for deductions in the sense that permitted deductions are confined to outgoings and expenses incurred in the production of profits in respect of which tax is chargeable; that such permitted deductions expressly exclude those in section 17. **In the opinion of their Lordships commercial considerations are not wholly to be disregarded in the course of this process.** They are relevant for the purpose of deciding what can properly treated as "outgoings and expenses … incurred during the basis period … in the production of profits in respect of which" the taxpayer is chargeable to tax." [Emphasis added]

WHICH COMMERCIAL ACCOUNTING STANDARDS APPLY?

18. The basic position of the Department, under the revised practice, is that the taxation treatment of a prepayment should be in accordance with the manner in which the prepayment is required to be treated for accounting purposes under the relevant financial reporting standards prescribed by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). In circumstances where a taxpayer is given a choice under those standards as to how a prepayment should be treated, the taxation treatment is to reflect the choice adopted, provided that it is not inconsistent with any provision of the Ordinance. In this regard, the following statement of Lord Millett in Secan, at page 330, is considered to be relevant –

> "Where the taxpayer may properly draw its financial statements on either of two alternative bases, the Commissioner is both entitled and bound to ascertain the assessable profits on whichever basis the taxpayer has chosen to adopt. He is bound to do so because he has no power to alter the basis on which the taxpayer has drawn its financial statements unless it is inconsistent with a provision of the Ordinance. But he is also entitled to do so, with the result that the taxpayer is effectively bound by its own choice, not because of any estoppel, but because it is the Commissioner's function to make the assessment and for the taxpayer to show that it is wrong."

Foreign corporations

19. Whilst the Department's position is that strictly speaking financial statements should be prepared in accordance with the financial reporting standards prescribed by the HKICPA, it is recognised that the accounts of companies incorporated outside Hong Kong (and the branches of such companies) which are carrying on business in Hong Kong may be prepared on the basis of standards which vary from those in Hong Kong. In such a case, in so far as any prepayment is affected, the Department will generally accept accounting treatment which is: (i) in accordance with the relevant financial reporting standard of the "home" jurisdiction or International Accounting / Financial Reporting Standards (i.e. those standards issued by the International Accounting Standards Board); and (ii) consistent with the true facts or otherwise apt to determine the true profits or losses of the business. It is emphasized that although the financial reporting standards of the home jurisdiction may be accepted under the above-mentioned circumstances, the accounting profits or losses would have to be adjusted in accordance with the provisions of the Ordinance and the established taxation principles. If the home jurisdiction does not have any applicable financial reporting standard, an adjustment of the accounting profits should be made in the Profits Tax computation to reflect the manner in which the financial reporting standards prescribed by the HKICPA would have applied to the prepayment. Incidents of varying standards should be of rare occurrence, as the accounting treatment of prepayments is in accordance with the universal fundamental concepts of "accrual" and "prudence".

APPLICATION

20. The revised practice will be applied by the Department in relation to any prepayment that is made during the basis period of a taxpayer for the 2002/2003 year of assessment and subsequent years. Accordingly, taxpayers and their representatives are advised that in preparing Profits Tax returns for these years of assessment, the revised practice explained above should be adopted.

21. Where a deduction has in effect been allowed in an earlier year of assessment (i.e. prior to 2002/2003) for a prepayment (or part of a prepayment)

in accordance with the “old” practice, it will not be accepted that any further deduction can subsequently be allowed in respect of the same amount in 2002/2003 or any subsequent year of assessment. Clearly, if the Department were not to take this approach, such amounts would in effect be deducted twice.