



Commonly Asked Questions on Departmental Interpretation and Practice Notes (“DIPN”) No. 40 – Profits Tax: Prepaid or Deferred Revenue Expenses

Foreword

The following questions and answers have been prepared to highlight some of the key points covered by the above DIPN. Taxpayers are, however, advised to read the full text of the DIPN if their taxation affairs involve any issues concerning prepaid or deferred revenue expenses. The DIPN can be downloaded from the Department’s website at http://www.ird.gov.hk/eng/pdf/e_dipn40.pdf.

Q.1 What kind of expense is this DIPN concerned with?

A.1 This DIPN is concerned with revenue expenses that are paid in advance of the periods to which they are related. Common examples of prepaid expenses are insurance premiums, car licence fees, rates and subscription fees. Very often, the period covered by a prepaid expense extends beyond the end of the accounting year in which it is paid and the expense is apportioned and charged to the profit and loss accounts of more than one year. This DIPN deals with the timing of deductions of such expenses for tax purposes.

Q.2 What exactly are the “old” practice and the revised practice for the deductions of prepaid or deferred revenue expenses as mentioned in the DIPN?

A.2 Under the “old” practice, a taxpayer may be allowed to claim a deduction for the whole sum of a prepaid expense in the year of payment even if the sum is related to more than one accounting year and is spread over and charged to the profit and loss accounts of those years.

Under the revised practice, a taxpayer is not allowed to claim deduction for the full amount of a prepaid expense in the year of payment if any part of the expense is deferred to a subsequent year or period. Deduction for a particular year is only granted for that part of the prepaid expense that is charged to the profit and loss account of that year, provided that the accounts are prepared in accordance with the relevant financial reporting standards.

You may also refer to the examples at the end of this leaflet for a better understanding of the “old” and revised practices.

Q.3 When will the revised practice commence to take effect?

A.3 The revised practice applies to any prepayment that is made during the basis period of a taxpayer for the year of assessment 2002/03 and subsequent years.

Q.4 Why does the IRD change its practice?

A.4 Following the Court of Final Appeal's decision in *CIR v. Secan Limited & Ranon Limited*, it is clear that assessable profits must be ascertained in accordance with the ordinary principles of commercial accounting as modified to conform with the Inland Revenue Ordinance. The Department is of the view that the "old" practice is inconsistent with this principle and therefore decides to change its practice.

Q.5 How does the IRD decide what accounting treatment for a prepaid expense is acceptable?

A.5 The Department would accept the accounting treatment of a prepaid expense as correct if it complies with the relevant financial reporting standards prescribed by the Hong Kong Institute of Certified Public Accountants and is not inconsistent with any provision of the Inland Revenue Ordinance. (Also see Question 7 below.)

Q.6 What financial reporting standards are to apply if the taxpayer is a foreign company, i.e. a company incorporated outside Hong Kong?

A.6 Where the accounts of a foreign company are prepared on the basis of financial reporting standards different from those in Hong Kong, the Department would accept the accounting treatment of a prepaid expense as correct if such treatment complies with the relevant financial reporting standard of the home jurisdiction of the foreign company or International Accounting / Financial Reporting Standards, and is consistent with the true facts or otherwise apt to determine the true profit or loss of the business. However, the accounting profits or losses would have to be adjusted in accordance with the provisions of the Ordinance and the established taxation principles.

If, however, the accounts of the foreign company are prepared on the basis of the financial reporting standards in Hong Kong (for example, where the foreign company is a subsidiary of a Hong Kong company), the Department would require that the accounting treatment of any prepaid expense complies with the relevant financial reporting standards prescribed by the Hong Kong Institute of Certified Public Accountants.

Q.7 Does the DIPN mean that taxation treatment of a prepaid expense will follow the accounting treatment adopted by a taxpayer so long as the accounting treatment complies with the relevant financial reporting standard?

A.7 On the question of timing of deduction of a prepaid revenue expense, taxation treatment will follow the accounting treatment adopted provided that it complies with the relevant financial reporting standard and is consistent with the tax law. Therefore, it is necessary to consider whether the expense is deductible at all in the

first place. In this regard, the provisions of the Inland Revenue Ordinance must be considered. For example, where an expense is not incurred in the production of chargeable profits as provided under section 16(1) of the Ordinance or is prohibited from deduction under section 17, it is not allowable for deduction regardless of the accounting treatment given to it.

Q.8 Is the revised practice also applicable to businesses whose accounts are not prepared by professional accountants or are not required by law to be audited?

A.8 Yes. The revised practice is to be applied to all businesses in the same way.

Q.9 What will the IRD do if the accounting treatment adopted by a taxpayer for a prepaid expense does not comply with the relevant financial reporting standard?

A.9 If the accounting treatment adopted by a taxpayer for any prepaid expense is inconsistent with the relevant financial reporting standard, adjustment would be made to the accounting profit to compute the profit that should have been arrived at had the relevant financial reporting standard been applied in the accounts.

However, where the amounts involved are immaterial and it is permissible under the relevant financial reporting standard not to defer the charging of the expenses, no tax adjustment will be made.

Q.10 Returns for the years of assessment 1999/2000 and 2000/01 have been issued to me, should I follow the “old” practice or the revised practice for prepaid expenses in my profits tax computations for these years?

A.10 For years of assessment up to and including 2001/02, you can still claim deductions for prepayments as allowed under the “old” practice. You are of course not obliged to do so and may simply follow the revised practice in the returns to be submitted. Whichever practice you follow, the Department would need to be satisfied that no deduction for any part of the same expense is allowed more than once. Accordingly, depending on how prepaid expenses have been treated in your tax assessments for other years, it may be necessary to make adjustments to the assessable profits for the years involved.

Q.11 My company has not made any deduction claim for prepayments in all the returns submitted. Will any adjustment be made to my company’s assessable profits as a result of the change in practice mentioned in this DIPN?

A.11 No.

Q.12 Is the revised practice also applicable to scientific research expenditure deductible under section 16B of the Inland Revenue Ordinance and expenditure

on the purchase of patent rights deductible under section 16E?

- A.12 No. The revised practice will not be applied to these expenditures. Full deductions for expenditures falling within these two categories will be granted in the year in which the expenditures are incurred.

Examples to illustrate the “old” practice and the revised practice

Example A

- Company X closes its accounts on 31 December each year. On 15 May 2001, it entered into an agreement for the maintenance of its computer equipment for one year from 1 June 2001 to 31 May 2002 and paid a maintenance fee of \$120,000 in advance for the whole maintenance period. The fee is charged/to be charged in Company X’s profit and loss accounts as follows:

Year of Assessment	2001/02	2002/03
Accounting year ended	31 December 2001	31 December 2002
Maintenance fee		
(\$120,000 x 7/12, i.e. 01.06.01 – 31.12.01)	\$70,000	
(\$120,000 x 5/12, i.e. 01.01.02 – 31.05.02)		\$50,000

- Company X claims that, notwithstanding its accounting treatment, the whole of the maintenance fee of \$120,000 should be allowed for tax deduction in the year of assessment 2001/02.
- Under the “old” practice, the Department would allow Company X’s deduction claim for the whole sum of \$120,000 in the year of assessment 2001/02.
- The sum of \$50,000 charged in Company X’s accounts for the year of assessment 2002/03 will be added back to the company’s assessable profit for that year because the sum has been deducted in computing the assessable profit for the preceding year.

Example B

- Following from Example A, on 15 May 2002, Company X entered into a renewed agreement for the maintenance of its computer equipment for another year from 1 June 2002 to 31 May 2003 and paid a maintenance fee of \$180,000 in advance for the whole maintenance period. The fee is to be charged in Company X's profit and loss accounts as follows:

Year of Assessment	2002/03	2003/04
Accounting year ended	31 December 2002	31 December 2003
Maintenance fee for the renewed agreement		
(\$180,000 x 7/12, i.e. 01.06.02 – 31.12.02)	\$105,000	
(\$180,000 x 5/12, i.e. 01.01.03 – 31.05.03)		\$75,000

- As the payment is made during the basis period for the year of assessment 2002/03, the revised practice applies. Company X will not be allowed to claim a tax deduction for the whole sum of \$180,000 in the year of assessment 2002/03. Instead, it is only allowed to claim tax deductions in the same amounts as they are charged to its profit and loss accounts, i.e. \$105,000 for 2002/03 and \$75,000 for 2003/04.
- The sum of \$50,000 for the period 1 January to 31 May 2002 under the first maintenance agreement (see Example A) will also be charged in the profit and loss account for the year of assessment 2002/03. This sum, however, is not deductible and has to be added back to the company's assessable profit for the year of assessment 2002/03 as it has already been deducted in the year of assessment 2001/02.

Last update date: 1 April 2011

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