CACV 20/1999

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION

COURT OF APPEAL

CIVIL APPEAL NO. 20 OF 1999

(ON APPEAL FROM HCIA 3/1998)

BETWEEN

SECAN LIMITED	Appellant (Respondent)
and	
COMMISSIONER OF INLAND REVENUE	Respondent (Appellant)

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CIVIL APPEAL NO. 21 OF 1999

(ON APPEAL FROM HCIA 4/1998)

BETWEEN

RANON LIMITED	Appellant (Respondent)
and	

COMMISSIONER OF INLAND REVENUE Respondent (Appellant)

Before : Hon Godfrey JA (appointed Vice-President on 28.1.2000), Rogers JA and Woo J (since 27.1.2000 Woo JA) in Court

Dates of Hearing : 11, 12 and 13 January 2000

Date of Judgment : 16 February 2000

J U D G M E N T

Hon Godfrey VP :

Introduction

These appeals come to the court by way of a case stated for its opinion by a Board of Review under section 69 of the Inland Revenue Ordinance, Cap. 112 ("the Ordinance"). The questions raised by the stated case were answered by Cheung J in favour of the taxpayers (Secan Limited and Ramon Limited); and from his decision, the Commissioner of Inland Revenue now appeals.

The taxpayers are members of the Cheung Kong group of companies, in the business of property development. The first was responsible for the development of South Horizons, Ap Lei Chau; the second for the development of Laguna City, Kwun Tong. The taxpayers met the cost of carrying out these developments by borrowing from financial institutions. The interest charges on these borrowings, as charges against revenue, could legitimately have been shown in the taxpayers' financial statements as expended in the year in which they were incurred. Alternatively, and equally legitimately, they could have been (and in fact were) capitalised; that is to say, *not* shown in the taxpayers' financial statements as expended in the year in which they were incurred, but taken into account in their balance sheets as part of the costs of the developments. The capitalisation of interest (and of other development costs) has the advantage of enabling a developer to prepare his financial statements on a basis which does not show a "loss" in the years while the property is still under development, except in relation to those of his (comparatively trivial) expenses which he cannot legitimately treat as part of the

costs of the development. For a public company (or a wholly owned "single development" subsidiary of such a company) this is an attractive option and one generally, if not universally, adopted.

However, for the purposes of computing its assessable profits for tax purposes in any year, it is to the advantage of the developer' s cash flow (it does not affect the *amount* of tax payable) to have these interest charges treated as expended in the year in which they were incurred, notwithstanding their capitalisation in his financial statements.

This is the genesis of the difference here between the revenue and the taxpayers. The revenue says that having capitalised the interest charges in their annual financial statements, the taxpayers cannot now, after realisation of the development, treat these interest charges, in the computation of their assessable profits for tax purposes, as expended in the year in which they were incurred. The taxpayers say that, on the contrary, they *are* entitled to do so; not only that, they cannot otherwise treat these interest charges as a deduction in the assessment of their assessable profits at all, a result which the legislature could not possibly have intended.

Counsel for the revenue and for the taxpayers accepted before us that the question we have to decide (although it cannot be said to have been so framed in the case stated) is whether, as a matter of law, this contention of the taxpayers is correct.

The relevant statutory provisions

The starting point is section 14 in Part IV of the Ordinance, which imposes the charge to "profits tax" with which the case is concerned. The tax is charged on "assessable profits". This expression is defined in section 2 of the Ordinance as meaning the profits on which a person is chargeable to tax for the basis period for any year of assessment, calculated in accordance with Part IV of the Ordinance; and the expression "basis period" for any year of assessment is itself defined in section 2 as the period on the profits of which tax for that year ultimately falls to be computed. Under section 16(1) of the Ordinance, there is to be deducted, in ascertaining the profits in which the taxpayer is chargeable to tax for any year of assessment all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment in the production of taxable profits for *any* period; under section 16(1)(a), such outgoings and expenses include interest on money borrowed for the purposes of producing such profits.

Under section 18 of the Ordinance, the "assessable profits" themselves are to be computed on the "full amount of the profits" of the taxpayer' s business during the year preceding the year of assessment. Under section 19C(4) of the Ordinance, a "loss" in any year of assessment is to be set off against the "assessable profits" of the taxpayer for that year of assessment and to the extent

not so set off is to be carried forward and set off against the taxpayer' s "assessable profits" for subsequent years of assessment.

The facts

The material facts are sufficiently summarised in the judgment of Woo J which I have had the advantage of reading in draft.

The revenue' s case

In summary (I hope the following fairly represents its arguments), the revenue says that the "full amount of the profits" of the taxpayers' business for any year of assessment must be computed for tax purposes in accordance with ordinary principles of commercial accounting. The taxpayers elected, as they were entitled to do, in accordance with such principles, to capitalise the interest charges they incurred, as their financial statements show. This election operated to establish the taxpayers' profits for the relevant years of assessment. The taxpayers cannot now be allowed to compute, or re-compute, their profits for tax purposes on a basis inconsistent with that election: that would not be "fair to the revenue" (Cp. per Lord Reid in *BSC Footwear Ltd v. Ridgway* (1971) 47 TC 495, at p.524.) The question is : What is "the true profit" of the taxpayer? (Cp. per Sir John Pennycuick V-C in *Odeon Associated Theatres v. Jones* (1971) 48 TC 257, at p.272.) The taxpayers have correctly shown their "true profits" in their financial statements taking capitalised interest straight to their balance sheets, in accordance with ordinary principles of commercial accounting, rather than showing it as a deductible expense in their profit and loss accounts. The taxpayers' "true profits" cannot be ascertained for tax purposes in some different way and there is nothing in the relevant statutory provisions which dictates otherwise. As a matter of "legal analysis", what was involved here in the capitalisation of the interest charges, although not made explicit in the taxpayers' financial statements, *was* a deduction of the interest charges in the years in which they were incurred but the crediting against them of a closing figure for work in progress as a notional receipt. (Cp. per Nolan LJ in *Gallagher v. Jones* [1994] Ch. 107 at p.136.) On this analysis, it becomes apparent that the taxpayers have already had the benefit of the deductions claimed, and cannot now be permitted to compute their "true profits" for tax purposes on a basis different from that properly empowered by them in preparing their financial statements.

The taxpayers' case

In summary (and again, I hope the following fairly represents their argument), the taxpayers say that under the relevant statutory provisions and, in particular, section 16 of the Ordinance, the taxpayers are entitled in computing their profits for any year of assessment (no matter how they may have elected to present their financial statements) to deduct the interest charges incurred

during the basis period for that year. The taxpayers accept that this means treating the interest charges as having been, not capitalised, but expensed. But that is what the relevant statutory provisions enable and indeed compel them to do. As was pointed out by Lord Bridge of Harwich, giving the judgment of the Privy Council in *Commissioner of Inland Revenue v. Hang Seng Bank Ltd* [1991] 1 AC 306 at p.319 :-

> "The net profits of a business before taxation in any given period can only be calculated by deducting from the aggregate income from all sources the aggregate expenses of the business of every kind."

Conclusion

I find myself compelled, with reluctance, to accept the taxpayers' argument, although I am of the opinion that this does not produce a result "fair to the revenue". Changing the goalposts is bound to seem unfair to the side which is disadvantaged by the operation. But the problem is that the relevant statutory provisions do, as I think, compel the deduction of the relevant interest charges in the ascertainment of the taxpayers' profits for each year of assessment, even though the preparation of their financial statements by the taxpayers in accordance with the relevant statutory provisions, rather than in accordance with the ordinary principles of commercial accounting (which indicate the capitalisation of such interest charges), would be unthinkable, since they would show very large "losses" in the years before the realisation of the developments.

I would accordingly dismiss these appeals; and, since Rogers JA and Woo JA agree, they will be dismissed (subject to the provisions of Order 42 rule 5B(6) of the Rules of the High Court) with costs.

Hon Rogers JA :

I agree that these appeals should be dismissed.

The simple reason is that, in my view, the judge below was correct in his decision and I consider it should not be disturbed.

The Stated Cases

Before turning to the issues in these cases, I would draw attention to the state of the Stated Cases. In my view, they were not in a form which was acceptable. I can do no better than

repeat a rather lengthy citation from the case of *Chinachem Investment Co. Ltd v. Commissioner of Inland Revenue*, CA No. 116/1986. Sir Alan Huggins V-P said :-

> "There was much discussion before us and before the judge as to the form of the Case Stated and the procedure for settling it. It has never ceased to amaze me how much argument this simple and straightforward process engenders. A properly draft Case Stated is the most satisfactory process of all for deciding a question of law, for it concentrates attention on the essentials of the case, but it does require those concerned to marshall and state with precision the issues, the facts (and, where necessary, the evidence), the arguments and, finally, the conclusions attacked. Criticism was directed at the Board of Review for failing to produce an acceptable case. In my view that criticism was almost entirely misdirected. Whatever may be the present practice in England, the established practice in Hong Kong is that where parties are professionally represented they shall draft the Case Stated and submit it to the tribunal. The reason is obvious: the parties know better than anyone else what points they wish to take on the appeal, what findings of fact they wish to contend are relevant to those points and what arguments they advanced. The tribunal has the final responsibility for stating the Case and is not bound by the draft submitted to it. It can, therefore, after consulting the parties, alter the draft if it is inaccurate or incomplete. Even if the drafting were to be done by the tribunal itself, it would be the duty of the parties to apply for any necessary amendment. As I have often said before, there may be cases where it is impossible adequately to state the Case without annexing one or more documents, but such cases are few and far between. The documents may even include a transcript of evidence, but that is to be avoided if possible, because such a transcript inevitably contains unessential matter which it is the object of the process to exclude. Thus, where the issue on appeal is whether there was any evidence to support a finding of fact, a transcript of all the evidence may be a necessary annexure, but a transcript is not to be annexed where what is required is a statement of the facts found or assumed or where with proper diligence a precis of the material evidence can be included in the Case Stated itself. I appreciate that in the present case it is urged that the facts should have been found and not assumed, but that is a different matter (which I shall deal with in an appropriate part of the judgment) involving a criticism of the Board' s Determination and not of the Case Stated.
>
> The Case as ultimately stated included no less than 513 pages, amongst which were the Commissioner' s Determination and copies of some law reports. On any view those were not documents which it was proper to annex. In the event, as was to be

anticipated, only about a score of the pages of exhibits were even referred to on the appeal."

In these cases, there were not only a total of 3 box files for each case but each Case Stated included as annexes not only the decision of the Board of Review, but the witness statements, the transcripts of the oral evidence, copies of submissions which were made to the Board of Review as well as agreed statements of fact which, in turn, had a large number of appendices. These, as Woo JA, points out in his judgment, all tended to obscure the question which the court was required to answer on the Stated Cases.

In conclusion, it was left to the Judge below to do what was, in effect, draft the Case Stated. This, he did in the first 15 pages of his judgment.

The questions on the Stated Cases

The questions of law which the Board framed for the High Court were based on the two issues which the parties had agreed should be decided by the Board.

Those agreed questions were as follows :-

"(1) First issue – whether or not the interest payable by the Appellant in each of the basis periods, 20th November 1987 to 31st December 1988, 1st January 1989 to 31st December 1989 and 1st January 1990 to 31st December 1990, has already been deducted under section 16(1) of the Inland Revenue Ordinance in the computation of assessable profits or adjusted losses shown on the tax returns originally submitted by the Appellant for the years of assessment, 1988/89, 1989/90 and 1990/91 (as per Appendix H to the Agreed Statement of Facts).

(2) Second issue – if so, whether the Appellant is entitled to re-open the accounts for those years."

The questions in the Case Stated in the Secan case were :-

"(1) Despite the agreed facts

(a) that the Appellant had taken no deduction for the interest payable of $810,463,750 (prior to claiming the same in its 1991/92 tax computation) either in its profit and loss account or tax computation; and

(b) had not brought into account in either its profit and loss account or tax computation (as a deduction or receipt) any amount representing the cost of land as work in progress or trading stock prior to its tax computation for the year of assessment 1991/92;

was the Board entitled to hold that there is a principle of law which establishes that the Appellant is to be treated (contrary to fact) as if such deduction as in (1)(a) above and such action as in (1)(b) above had in fact occurred?

(2) If and insofar as the Board' s conclusion was a conclusion of law was it one which, in law, was open to the Board on the facts found by it or, in consequence of (3) and (4) below, should have been found by it?

(3) If and insofar as the Board' s conclusion that the said interest had already been deducted was a finding of fact was there evidence to support such finding in light of the Agreed Statement of Facts?

(4) If there was no agreement to nor was there evidence to support the Board' s amendment to paragraph 17 of the Agreed Statement of Facts set out on page 31 of the Board' s decision whether such amendment could be made?"

That in respect of the *Ranon* case was similar and the differences are immaterial for the purposes of this case.

These cases concern interest which has been incurred by the Taxpayers in respect of loans taken out to finance the development of building projects where the flats built were to be sold.

The terms expensing and capitalising have been used in relation to the treatment of interest for accounting purposes.

If the item of interest remains in the profit and loss account at the end of the year, and is deducted against any income to reduce the profit shown, it is referred to as expensing the interest.

The alternative treatment of interest is to capitalise it. This process involves adding the cost of the interest in any one year to the cost of the work in progress, thus increasing the value of the work in progress.

Capitalising interest on a project by development companies during the process of construction is a normal and reasonable practice. It is agreed between the parties that in respect of public property companies in Hong Kong, it is the invariable practice for interest on loans, used to finance projects, to be capitalised. When the project is completed and the development sold, the interest element is taken into account in calculating the profit and loss because it forms part of the cost of the work in progress. The advantage to a public company of capitalising interest is that it does not have to declare a loss caused by interest charges during the years of development of a project. To have to declare a loss or to reduce profits, might have adverse effects on share value and indeed, upon dividends payable. In respect of private companies, the incentive to capitalise interest is perhaps the reverse. There, the incentive to reduce the discloseable profits and thus reduce taxation looms far higher.

Clearly, the first issue before the Board had to be decided before there could be any question of re-opening the accounts. On the face of the first issue before the Board, it would appear that the question would be one of fact. The Board of Review is the tribunal of fact and against their findings of fact, where properly made, there is no appeal. The only appeal is one as to law. It is notable, however, in the present cases that the Board's decision in relation to the first issue appears to treat matters of accounting as matters of law. Paragraph 4 under the heading "Our decision" appears, indeed, to make the decision of the Board one of law. Whereas, I do not consider that on an appeal by way of Case Stated, it is desirable to go behind the question asked, here, in view of the inclusion of the Board's Decision as part of the Stated Cases, that exercise becomes more legitimate. Consideration of the Board's Decision thus shows that the matter sought to be raised by Case Stated had been treated by the Board as a question of law.

The position of the Parties

The notable feature of this case is that it is argued on behalf of the Revenue that the total amount of interest which has been incurred in respect of loans taken out to finance the developments is deductible for the purposes of ascertaining chargeable profits. The Revenue's position is that because that interest had, over the initial years, been treated as capitalised in the accounts prepared by the companies for the purposes of the Companies Ordinance, only that proportion of the total interest may be taken into account in any year which related to those parts of the developments which were sold in that year and a profit (or loss) thereby realised thereon.

The Taxpayers, on the other hand, seek to deduct the whole of the cost of the interest from the profits immediately, which in practice would mean that it would impact on the tax payable on the profits arising in the first years of sales (and thus the first years in which there had been profits in respect of the developments).

The question is, therefore, one of cash flow. The matter in dispute is when, and not if, the interest may be deducted for tax purposes. What is seemingly at stake in this case is the benefit of the accelerated cash flow which the taxpayer would enjoy if successful.

The Revenue's argument

The Revenue's argument is really threefold. First that the Taxpayers have deducted interest incurred during the years it was incurred. This, it is said, has happened by reason of the fact that interest has been capitalised in the companies' accounts and the amounts of interest have been added to the costs of the developments. It is said that when the figure of profit is calculated for the purposes of Section 14 of the Inland Revenue Ordinance, the development costs are notionally added to and debited from the profit and loss account each year until the development is disposed of. The process of capitalisation of interest results in the capitalised interest being added to the development costs year by year. In this way, the interest that has been added to the development costs is implicitly, even if not explicitly, included in the profit and loss account and hence the calculation of profit each year.

This conclusion which is said to follow in consequence of the process of capitalisation of interest in the company accounts is said to be a matter of law. It is also said to be a matter of fact that that is what actually happened.

As a further point, it is said that since the Taxpayers have prepared their company accounts on the basis of capitalising the interest payments, when it comes to computation of tax, a deduction may not be made under Section 16(1)(a) of the Inland Revenue Ordinance. It is said that to do so would be to change the basis of accounting and that would be impermissible. In that respect, the case of *Johnson v Brittania Airways Ltd* [1994] STC 763 is relied upon.

The primary argument- whether the interest was deducted in each of the years prior to the year of assessment 1991/92 (in the case of Secan) and 1990/91 (in the case of Ranon) as part of the process of arriving at the figure of profits?

As noted above, it was argued that as a matter of book keeping, the figures of capitalised interest would be implicit, if not explicit, in the calculation of profit year by year. For the purposes of this argument, it would be assumed that this would apply equally to the calculation of assessable profits for the purposes of the Inland Revenue Ordinance as to the drawing up of the profit

and loss accounts. I will deal with question of whether this is a matter of law below, but it is necessary first, to see whether this is so as a question of fact and accounting practice.

Company Accounts

I would make brief mention of matters relating to company accounts which are obligatory under the provisions of the Companies Ordinance, Cap. 32.

Section 123(2) of the Companies Ordinance provides that the accounts of the company and specifically the profit and loss account should be prepared in accordance with the Tenth Schedule. Paragraph 13(1) of the Tenth Schedule provides :-

"There shall be shown - …(b) the amount of the interest on loans …"

It is of significance at this stage to note that the Companies Ordinance does not require the profit and loss account to be calculated on the basis that interest payable is a deduction. It is simply that the amount of interest must be disclosed in the profit and loss account. This point was confirmed by Mr Fong Hup, the accountant responsible for the Taxpayer's accounts, at page 4, F, page 7R and page 27K of the transcript of his cross-examination. At letter J, he made the point that "shown" does not mean "charged to".

At one point in the argument, Mr Milne QC, appearing on behalf of the Revenue, relied on the entry note (2) of the accounts of Ranon for the period 20 November 1987 to 31 December 1998 to say that the Statement of Standard Accounting Practice 2.205 did not dictate its presence. But in saying that, he clearly overlooked both the provisions of the Companies Ordinance and Mr Fong's answers.

Whether interest was deducted in the accounts for the purpose of calculating profit prior to the year of assessment 1991/92 (in respect of Secan) and 1990/91 (in respect of Ranon) as a matter of fact?

As regards the company accounts, the accounting evidence in this case appears to me to have been clear that interest was not deducted in the calculation of profits in the companies' accounts prior to the computation of tax for the year 1991/92 and 1990/91 for Secan and Ranon respectively. It is correct to say that in the accounts in the basis periods of the years of assessment prior thereto, the interest was treated as capitalised. Indeed, the Taxpayers aver that there is no intention to change that. Mr Fong Hup was questioned about this. Some of the questions appear to have been double or triple questions. In respect of one, for example, shown at page 8, letter K of the transcript, he was not allowed to finish his sentence and indeed, at letter M, it is clear that he was almost certainly

not giving the answer which the questioner was looking for. Since this was the passage which the Board must have had in mind when making its finding at IX 2. of its Decision, I consider that it was clearly wrong to have made such finding because it was based on a misunderstanding of what Mr Fong was saying.

What is clear is that as regards the accounting practice adopted by the taxpayer, there was no debit for interest in the accounts for the purpose of calculating profit. Interest paid was shown in the profit and loss accounts because that was required, as I have pointed out, by the Companies Ordinance; but it was not debited. In one case, the interest was directly debited to the development account and in the other, there was a ledger called "the interest paid" and from that, it was transferred before preparation of the profit and loss account to the costs of development.

As I have already mentioned, the fact that the interest paid during the year is thus disclosed in the profit and loss account of a company accounts does not mean that it has been deducted for the purpose of calculating the profit. Mr Fong was clear that it had not been in the present cases : see for example page 4N. He said at page 6K, for example, that the interest in the Secan accounts had been put to the development accounts without going through the profit and loss account. In Ranon, the interest was in the interest paid account and at the end of the year transferred to the development account page 6 N-R.

Mr Milne placed much reliance on an extract from the textbook Spicer & Pegler "Practical Book Keeping and Commercial Knowledge". But that was never put to Mr Fong in cross-examination and even if it had been, there is no reason to suppose that his answers would have been any different. Whatever might have been the theoretical concept behind book keeping in respect of companies that have turnover of their work in progress or stock-in-trade and are thus in the process of producing profits therefrom, it is clear that the accounts of the Taxpayers have been prepared on the basis which Mr Fong explained in his evidence. The Taxpayers had not commenced any sales prior to the basis period for the year of assessment 1991/92 (Secan) and hence there was no possible profit from any such source.

Neither actually nor even notionally was interest deducted in the profit and loss accounts and it did not have to be because no account was taken of work in progress at all for the purposes of calculation of profit until profits became relevant by reason of the commencement of sales. Nothing in this, it seems to me, is otherwise than in accordance with standard accounting practice. It clearly was not shown to be so.

Whether as a matter of law the Taxpayers must be treated as having deducted interest?

The argument for the appellant Commissioner that as a matter of law, interest has already been taken into account relies for its foundation upon the judgment of Lord Clyde in *Whimster & Co. v. IRC*, 12 TC 813 where Lord Clyde said at p.823 :

> "In computing the balance of profits and gains for the purposes of Income Tax, or for the purposes of Excess Profits Duty, two general and fundamental commonplaces have always to be kept in mind. In the first place, the profits of any particular year or accounting period must be taken to consist of the difference between the receipts from the trade or business during such year or accounting period and the expenditure laid out to earn those receipts. In the second place, the account of profit and loss to be made up for the purpose of ascertaining that difference must be framed consistently with the ordinary principles of commercial accounting, so far as applicable, and in conformity with the rules of the Income Tax Act, or of that Act as modified by the provisions and schedules of the Acts regulating Excess Profits Duty, as the case may be. For example, the ordinary principles of commercial accounting require that in the profit and loss account of a merchant's or manufacturer's business the values of the stock-in-trade at the beginning and at the end of the period covered by the account should be entered at cost or market price, whichever is the lower; although there is nothing about this in the taxing statutes."

What is argued is that this passage, together with passages in other cases, for example, Nolan LJ in *Gallagher v. Jones* [1994] Ch. 107 at 135H-136F, lays down as a matter of law that the value of the work in progress, i.e. in these cases the development costs which thus include the interest paid in any year, would have to be used in the calculation of profit.

In the last sentence in the passage from Lord Clyde's judgment quoted above, he was doing no more than citing as an example what he understood to be ordinary commercial accounting principles.

The culmination of the cases seems to me to lie in the passage in Nolan LJ's judgment to which I have referred above :-

> "Mr. Glick for the Crown submitted that there is a well established precedent for such a disallowance in the accountancy practice whereby unsold stock-in-trade is brought into account at the beginning and at the end of the period at the lower of cost or market value, a practice recognised and approved for tax purposes as long ago as 1925 *Whimster & Co. v. Inland Revenue Commissioners*, 1926 S.C. 20; 12 T.C.

813. The effect of this practice, said Mr. Glick, is to disallow the deduction of the trader' s expenditure on the unsold stock, or so much of it as is represented by the market value, if lower, and carry it forward to be set against the price for which the stock is ultimately sold. That is certainly one way of describing the effect of the practice, and comes close to the language of Lord Reid in *Duple Motor Bodies Ltd. v. Inland Revenue Commissioners* [1961] 1 W.L.R. 739, 754, where speaking of stock-in-trade and work in progress, he said:

> ' So the question is not what expenditure it is proper to leave in the account as attributable to goods sold during the year, but what expenditure it is proper, in effect, to exclude from the account by setting against it a figure representing stock-in-trade and work in progress.'

That is how he described the effect of the practice, but it is I think clear from the earlier part of his speech, at pp. 751-753, that as a matter of legal analysis he regarded the practice as involving the deduction of the whole of the expenses incurred during the period but the crediting against them of a closing figure for unsold stock and for work in progress as a notional receipt. Thus in the passage immediately preceding that which I have quoted he said, at p.753 :

> ' It has long been established that you are entitled to include in expenditure for the year all business expenses in that year not excluded by the old rule 3, now section 137 of the Income Tax Act 1952, whether or not they can be attributed to the production of goods in that year.'

In the same case Viscount Simonds and Lord Guest spoke in similar terms, and both used the words ' receipt' with reference to the closing figure for stock and work in progress: see per Viscount Simonds, at p.749, and per Lord Guest at pp.759 and 760, quoting Rowlatt J in *Naval Colliery Co. Ltd. v. Inland Revenue Commissioners* (1928) 12 T.C. 1017."

Two points should be noted. The first is that what he said clearly related to the ascertainment of profit where there was profit by reason of an on-going business where there was, what might be termed "stock-in-trade" or "work in progress" which was the subject of turnover. In the second place, the process of taking into account the value of the stock in trade at the beginning and at the end of the accounting period is a process which can be used, and consistently is used, by the manufacturers of products or by merchants. In those cases, it may often be difficult to ascertain the cost of manufacturing specific articles and hence, the profit for the period can be calculated by

deducting expenses from accountable receipts and adjusting it by reference to whether the work in progress or stock-in-trade has increased or decreased.

Turning specifically, as an example, in the present cases, to the case of Secan, it was not until November 1991 that the occupation permit for the first part of the development was issued. It was only then that sales were made. In the accounting periods prior thereto, there had been no question of any profit from the developments. There was no turnover. Hence, there was no question of and certainly no necessity for taking account of the value of the work in progress, either at the beginning or at the end of the accounting period.

It cannot be a matter of law that the calculation of profits, for the purposes of Section 14, of a company which has yet to generate profits from turnover, that the starting and closing figures of work in progress or stock in trade have been included in the calculation of profit in the profit and loss account. It is noteworthy that it was never put to Mr Fong that the figures of work in progress had been part of the profit and loss accounts in the years prior to year of assessment 1991/92.

Hence, it seems to me, the simple answer to the appellant's case is that for the purposes of section 16, there had been no deduction of interest and there is no rule of law which dictates that it must be treated as having been deducted.

The third argument

The Appellant's further argument verged to the point where it was being said that there was some kind of estoppel against the Taxpayers in that since the companies' accounts had been made up on the basis that the interest had been capitalised, it was not open to the Taxpayers to claim a deduction of interest for tax purposes. The point is made that that part of the interest attributable to the flats sold in 1991 forms part of calculation of profit, because it has been capitalised and thus included in the cost of the flats, whereas only the balance of the interest is claimed as a deduction carried through from the years incurred under the provisions of section 19C(4) of the Inland Revenue Ordinance.

The Revenue's argument has a superficial attraction in that the notion that it would be possible to have different figures for profit depending on whether one was considering the tax computation or the company accounts could, on first impression, seem alarming. However, it is important to consider what is in issue in respect of each matter and whether the profit figure in the company accounts can differ from that in the tax computation.

Whether the result of a calculation of assessable profits in accordance with Section 14 of the Inland Revenue Ordinance would be the same as the net figure in a company's profit and loss account?

A number of points arise. The first is as to whether computations prepared for taxation could show different items and in different ways to the accounts prepared in compliance with the provisions of the Companies Ordinance. In my view, the answer must be in the affirmative. A simple comparison of the Tenth Schedule with the provisions of the Inland Revenue Ordinance, shows that different items have to be taken into account even though what might be referred to at the end of the day is, on the one hand, profit and loss, and on the other hand, assessable profits.

Perhaps the most obvious point is that it has been a feature of the Inland Revenue Ordinance from the very beginning, and indeed of its predecessor the War Revenue Ordinance, that tax is only payable on profits arising in Hong Kong. The Company accounts must, naturally, show all income and all profits of the company no matter where they arise.

Another matter that is left out of calculation in arriving at assessable profits for tax purposes is the tax paid. That, however, is something that must be shown in the profit and loss account produced in accordance with Schedule 10 of the Companies Ordinance, see paragraph 13(1)(c).

Mention could also be made of the fact that paragraph 13(1)(j) of Schedule 10 requires that dividends paid or proposed to be paid shall be shown in the profit and loss account. These, again, are not deductible for the purposes of calculating profits under the Inland Revenue Ordinance.

In other respects, figures for what are, in essence, the same category of item are likely to be quite different in the profit and loss account and the tax computation. For example, the figures for the reduction in value of capital assets are unlikely to be the same. Accounting policies vary in relation to how depreciation will be calculated for the purposes of company accounts. A common practice is to take what is a straight-line deprecation, writing off an equal amount in each year over the anticipated life of a particular asset. Under paragraph 13(1)(a) of Schedule 10, the amount charged to revenue in this respect must also be shown in the profit and loss account. For tax purposes, the Revenue will normally permit an allowance based on the then current value of the asset. The 2 figures arising from the reduction in value of the same asset may thus be very different. Indeed, the allowance figures allowed by the Inland Revenue might be such that if the same figures were taken for the purposes of depreciation in the profit and loss account, the company accounts might not give a true and fair view of the profit and loss of the company.

Examples of the above, in relation to Secan, can be seen in the profit and loss account for the year ended 31 December 1991 and in the profits tax computation for the year of assessment 1991/92 which is schedule 1 to the profits tax return for that year. In the profit and loss account, the tax considered to be payable and the interim dividend is shown. Those, of course, are not included in the tax computation. When it came to the tax computation, the depreciation on plant and machinery shown in note (6) to the accounts was added back but there were far more substantial allowances that were included for tax purposes.

Once the true nature of the accounts which are required under the Companies Ordinance are appreciated and due note is made of the basis of the calculation of assessable profits under the Inland Revenue Ordinance, little more need be said to show that, beyond any doubt, the 2 matters are different.

It should also be remembered that accounts of private companies are not required to be filed with the annual return : see section 109(3), Companies Ordinance. Hence they are not publicly available. They are produced primarily for the benefit of the shareholders : see sections 122, 129G and 129F, Companies Ordinance and of those who can persuade the company to provide them. It is true that public companies publish consolidated group accounts; but little can be gleaned about individual companies' affairs if they are one of a number of group companies whose accounts have been consolidated.

Hence, the fact that something is shown in the profit and loss account produced in accordance with the Companies Ordinance does not bear on the question of whether the same figure should be shown (or taken as shown) in the calculation of assessable profits under the Inland Revenue Ordinance.

In the present cases, the Revenue has sought to rely upon the accounts produced in compliance with the Companies Ordinance in the periods prior to the basis period for the year of assessment 1991/92 and 1990/91 respectively to argue that because the interest paid on the capital borrowed to finance the developments was capitalised, the Taxpayers were not entitled to deduct interest paid in the year it was paid in accordance with Section 16(1)(a) of the Inland Revenue Ordinance. That, in my view, must be wrong. In the first place, the provisions of section 16(1) appear to be mandatory. In the second place, in these cases, as I have indicated, interest was not deducted in the profit and loss accounts, either explicitly or implicitly. In the third place, company accounts are company accounts and they are not computations of assessable profits for tax purposes. I see no reason why if the tax computation is made in a legitimate way, it cannot differ from the company accounts.

I entirely agree with Woo JA that the cases cited by the Appellant as authority for saying that it is impermissible for the Taxpayer to claim interest once there has been capitalisation in the company accounts simply do not support that proposition. The judgments in the case of *Johnson v Brittania Airways Ltd* [1994] STC 763 simply held that a Taxpayer could compute the profit for the purposes equivalent to Section 14 in a way that was in accordance with ordinary accounting principles and the Revenue were not entitled to dictate to a Taxpayer how to make the computation provided the Taxpayer was using one of a number of accepted accounting bases. In these cases, the Taxpayers have calculated their assessable profits having taken into account the interest element of the cost of the flats sold and only seek to claim the balance of the interest incurred in the basis periods of the years of assessment prior to 1991/92 and 1990/91 carried forward in accordance with section 19C(4).

The Floodgates argument

It was tentatively sought to be argued on behalf of the Revenue that should these appeals not succeed it would open the way to all property companies and indeed other companies who, during a year, incurred expenditure on stock or work-in-progress which remained in their ownership at the end of the year, to claim a tax deduction based on the cost of the stock or work-in-progress which remained in their ownership at the end of the year, thus generating a loss notwithstanding their accounts would show no loss at all.

There are 2 answers to this attempt to generate fear of a fiscal disaster. The first is that Section 16 of the Inland Revenue itself provides that outgoings and expenses incurred during the basis period shall be deducted in ascertaining the profits. The consequence is thus not only may an expense be deducted in the year it is incurred but it must be. It cannot therefore be wrong to do so. The fact that the company accounts may not show such a deduction as an item which is expensed, producing a loss, cannot affect the matter.

In the second place, the fear expressed in the argument could not materialise in cases where the value of the stock or work-in-progress is taken for purposes of calculating profit.

Conclusion

In conclusion, it remains to say that all the questions on the Stated Cases fall to be answered in the negative. I agree that this appeal should be dismissed.

Woo, J:

This is a simple case which has been clouded by reference to legal authorities and accounting principles. The only issue should have been one of fact: whether expenses by way of

interest payments or accruals had been taken into account in the computation of assessable profits for tax purposes of two property development companies, namely, Secan and Ranon. The complication of this simple issue has caused the Board of Review to hear the case on three days in 1996 and to give a decision 34 pages long, a three-day appeal by way of case stated before a Judge of the Court of First Instance in November 1998 who gave a 36-page judgment and arguments before this Court for another three days. All for the resolution of what ought to be a simple issue of fact which could have been ascertained simply by checking the accounts and tax returns of the companies or by the Inland Revenue Department raising queries for clarification.

Secan and Ranon were at all material times property development companies. As their cases are almost identical, it is only necessary to deal with Secan's case and the same result will apply to Ranon. That was what the Board of Review and Cheung J had done, and that is what I propose to do.

Secan was the developer of a project known as South Horizons at Ap Lei Chau, Hong Kong, mainly for resale. It is common for land-development companies in Hong Kong to have their projects financed by loans, resulting in interest having to be incurred. Interest incurred in such manner is always taken into account as part of the cost of the development, being treated in the same manner as cost for the land and costs for construction of the buildings. The way that such interest is almost always dealt with in the company accounts is to treat them as accrual or credit to the work in progress, which is being developed or made into existence, before the eventual sale of it by way of individual flats when the buildings are completed. When the flats are sold in a year of assessment for tax purposes, the assessment profits are arrived at by taking the receipts (mainly the proceeds of the sales of the flats) as reduced by the cost of the flats that can be ascertained (eg, by taking a certain proportion of the entirety of the work in progress which has become stock-in-trade as the number of flats sold bears upon the total number of flats built and being built). This is a simple way, by taking price less cost, to arrive at the assessable profit.

In the present case, it was stated in Secan's accounting documents that the interest incurred was capitalised, which means that it was added to the cost of the work in progress (called 'properties under development') before the flats were completed and sold. When some of the flats were completed and sold in the 1991, Secan claimed that it was entitled to reduce its receipts from the sale of the flats by the interest that had been incurred in the proportion of the flats sold as bearing upon all the flats sold and not yet sold (and this is accepted by the Commissioner), and on top of that by all the remaining interest incurred since 1988 up to 1990, to arrive at the assessable profits for 1991. Had Secan not "capitalised" the interest to make it part of the cost of properties under development, Mr Milne, QC, for the Commissioner, has conceded that there would have been no dispute that Secan is entitled to so treat the interest, ie, to "expense" the interest which would be reflected as a loss in Secan's accounts for 1988, 1989 and 1990.

The South Horizons project was a very large one, involving five phases, starting at the end of 1987. Phase I was completed in 1991 and 1992, and the last phase was completed as late as March 1995.

I believe it is common ground that when Phase I flats were sold in 1991, the accountants of Secan took into account the portion of the cost of the flats as developed, which included the interest and financing charges for those flats, for deduction from the proceeds or receipts to arrive at the assessable profits, and then to use the balance of the interest and financial charges incurred in the previous three years for other flats still under development ("the disputed interest") to reduce those assessable profits thus resulted to arrive at the actual assessable profits chargeable to profits tax. It is in respect of this reduction that dispute has arisen between the parties. The question is whether the disputed interest can properly be deducted from the assessable profits in 1991 or it should only be deducted from the assessable profits in later years in proportion of the flats sold in those subsequent years as bearing upon the entirety of the work in progress or properties under development.

On the one hand, Secan argues that it is entitled to deduct the whole of the disputed interest from the assessable profits in 1991 because such interest had been incurred since the commencement of the development right up to the time when profits were derived from the sale of some of the flats so developed. Although the disputed interest had not been claimed as losses in the years between 1988 and 1990 when they were incurred, they should be treated as expenses necessarily incurred for the production of the profits in 1991 subject to tax, pursuant to section 16(1)(a) of the Inland Revenue Ordinance ("IRO"). The disputed interest should properly be treated as losses incurred in the three years 1988, 1989 and 1990 and as such, they should be allowed to be carried forward pursuant to section 19C(4) of the IRO, as they had not been charged against any profits of Secan for those three years, to be used to reduce the assessable profits in 1991.

On the other hand, the Commissioner argues that as the disputed interest was not incurred for the production of the flats sold in 1991 but incurred for the production of the flats still unsold, it should not be allowed to be used to reduce the profits from the flats sold in 1991. The Commissioner also points out that since Secan' s accounts in 1989 and 1990 had capitalised all the disputed interest, such interest cannot be claimed as losses incurred in 1988 to 1990. It is implicit in the Commissioner' s submissions that the disputed interest can eventually be deducted from the receipts of years subsequent to 1991 when the other flats were sold, by way of it being part of the cost of the development used to reduce the receipts for arriving at the assessable profits for such subsequent years. The only dispute between the parties is the time when the disputed interest can and should be taken into account: Secan claims that it was entitled to use it to reduce its assessable profits in 1991 for the year of assessment 1991/92, whereas the Commissioner submits that it should only be used to

reduce the receipts in each of the years subsequent to 1991 from the sale of flats in such a year in order to arrive at the assessable profit for that year.

For resolving this dispute between the parties, it is necessary to look at the relevant provisions of the IRO. Section 16(1)(a) provides as follows:

> "(1) In ascertaining the profits in respect of which a person is chargeable to tax under this Part 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**, 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**, and sums payable by such person by way of legal fees, procuration fees, stamp duties and other expenses in connection with such borrowing;" (emphasis added)

Under s 16(1)(a), Secan was entitled in each of the years of assessment 1988/89, 1989/90 and 1990/91 to deduct the interest incurred during the relevant basis period as an outgoing or expense for the production of the chargeable profits for that year of assessment or for subsequent years of assessment. Had Secan done so, as there were no or little profits in those years the disputed interest would have appeared as losses in the accounts as well as losses in the tax computations submitted to the Inland Revenue Department. However, Secan had not done that, and instead capitalised the interest as part of the cost of the properties under development. The disputed interest was incurred in the basis periods of 1988, 1989 and 1990, and when dealing with the basis period of 1991 the disputed interest, in my view, cannot properly be deducted for calculation of the assessable profits for 1991 merely pursuant to s 16(1)(a), as it was not incurred "during the basis period" of 1991 in respect of the year of assessment 1991/92.

Section 19C(4) of the IRO provides as follows:

> "(4) Where in **any year of assessment** a corporation or a person, who is not an individual, a partnership or a corporation, carrying on a trade, profession or business sustains a **loss** in that trade, profession or business, the amount of that loss shall be **set off against the assessable profits** of the corporation or person (including its share of the assessable profits of a partnership in which it is a partner) **for that year of assessment** and to the extent not so set off, shall be **carried forward and set off against** the corporation's or the person's **assessable profits** and its share of

assessable profits of such a partnership **for subsequent years of assessment**." (emphasis added)

Can the disputed interest incurred by Secan in 1988, 1989 and 1990 be treated as a loss under s 19C(4)? It is not so treated in the accounts of Secan prepared by its accountants nor in the tax computations submitted by the accountants to the Inland Revenue Department, because it was treated as part and parcel of the cost of the properties under development. On the other hand, however, the word "loss" in the subsection cannot and should not, in my view, be interpreted only with reference to the way used for the treatment of the item in the accounts of the taxpayer, because that would be allowing form to override substance. Moreover, the word "loss" in the provision is not in terms limited to loss as reported to the Inland Revenue Department because it is expressly to be allowed to be used to set off against the assessable profits for the year of assessment during which the loss is sustained. Assessable profit is arrived at normally by receipt less cost, and if receipt is less than cost, there will be a loss. It is therefore possible that where there is a loss there may not be assessable profit for the same year. Thus, the word "loss" will not necessarily be a loss in the sense of a loss reported to the Inland Revenue Department or shown in the taxpayer' s accounts as such. It can just be an expenditure item not covered by a corresponding receipt item or by any receipt item. This interpretation is also supported by the provisions of s 19D of the IRO. In such circumstances, Secan was entitled pursuant to s 19C(4) to deduct the disputed interest from the assessable profits for the year of assessment 1991/92, insofar as it had not been used or applied to set off any assessable profits, although the disputed interest was incurred or paid in the years prior to 1991/92.

The Board of Review held for the Commissioner and decided that the disputed interest had already been deducted. The basis of the Board' s decision was that the disputed interest had been deducted by way of it being capitalised and reflected in the cost of the properties under development in Secan' s accounts. However, this decision failed to take into the account properly the issue that the Board had to decide. The issue, quoting from the Board' s decision at p. 13, is as follows:

> "First Issue : whether or not the interest payable by the Appellant, Secan Limited, in each of the basis periods, 20th November 1987 to 31st December, 1988, 1st January, 1989 to 31st December 1989 and 1st January, 1990 to 31st December 1990, has already been deducted under s. 16(1) of the Inland Revenue Ordinance in the computation of assessable profits or adjusted losses shown on the tax returns originally submitted by the Appellant for the years of assessment, 1988/89, 1989/90 and 1990/91 (as per Appendix H to the Statement of Agreed Facts)."

The relevant documents referred to in this issue are "the tax returns originally submitted by the Appellant for the years of assessment 1988/89, 1989/90 and 1990/91" and the issue is whether the disputed interest had already been deducted under s 16(1) of the IRO in the computation of

assessment profits or adjusted losses shown on such tax returns. It is obvious from the checking of such tax returns that the disputed interest had not been deducted. From the facts and evidence, the Board could only have answered this question by No instead of Yes. The Board's positive answer was based on the disputed interest having been taken into account by being capitalised to form part of the cost of the properties under development. However, the capitalisation was done in Secan's own accounts and not shown in the tax returns or the tax computation.

Cheung J, who heard the appeal from the Board by the taxpayers, dealt correctly and very clearly with this issue and the decision of the Board:

> "..it is clear that in the first three years the interest that was capitalised by Secan was not deducted in ascertaining the loss or profit for the purpose of tax assessment in those three years. It is demonstrated by the accountants' evidence given on behalf of Secan and Ranon. It is only in the year of assessment 1991/92 that Secan first claimed a deduction of all the interest and financial expenses."
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> The second and only other issue before the Board was:
>
> "Second Issue : if so, whether the Appellant is entitled to re-open the accounts for those years."

The Board decided that Secan was not entitled to re-open the accounts for the year of assessment 1988/89, 1989/90 and 1990/91. The Board apparently accepted the submission of the Commissioner based on *Johnston v Britannia Airways* [1994] STC 763 that the taxpayer was not entitled to change its basis for valuing work in progress from capitalising to expensing interest. On this point, the Judge commented:

> "The Commissioner also argued that having adopted the capitalisation basis, Secan is not entitled to change that basis for tax purposes. He relied on **Johnston (Inspector of Taxes) v Britannia Airways Ltd.** [1994] STC 763. In that case there were three alternative basis (sic) of providing for the cost of major engine overhauls of commercial aircraft. The Revenue tried to force an airline to adjust its method for tax purposes. It was held that where accounts were prepared in accordance with accepted principles of commercial accountancy the court would be slow to accept that they were not adequate for tax purposes as a true statement of the taxpayer's profits for the relevant period. In particular, it would be slow to find that there was a judge-made rule of law which prevented accounts prepared in accordance with the ordinary principles of commercial accountancy from complying with the requirements of the tax legislation. The determination of which method should be adopted to

attribute the costs of major overhauls to a period or periods of account was essentially a matter for accountancy judgment and there was no legal basis for excluding any of the possible methods.

In my view, this case is of no assistance to the Commissioner. Secan is not seeking to change an acceptable accounting method because the deduction of interest is by force of s. 16(1)(a). Furthermore, Secan can only be treated to have changed its accountancy method if by capitalising the interest, deduction was already made in the computation of profits. This clearly is not the case here."

In my opinion, the judgment cannot be faulted, especially if reliance is placed on s 19C(4) in addition to s 16(1)(a). Moreover, Secan was not seeking to change its accounting method. Secan was merely using and carrying forward the disputed interest as an item of accumulated loss incurred in its business in former basis periods to set off against the assessable profits for the year of assessment 1991/92. Secan is entitled to do so pursuant to s 19C(4) of the IRO.

Mr Milne argues that the disputed interest cannot be a loss within the ambit of s 19C(4). He proffers an example of an umbrella trader who spent money to buy umbrellas for sale. The money so spent must and should properly be treated as the cost of the stock-in-trade, and not a "loss" under s 19C(4). That may well be so. However, if the money was borrowed for which interest had been paid, the interest paid could be treated as an increased cost of the stock-in-trade but could also be equally convincingly treated as a loss, at the time with which the subject matter of this appeal is concerned. Mr Milne has not argued that there was any law or accounting principle that compelled the trader to treat such interest not as a loss but as an added cost, so as to deprive the trader from relying on ss 16(1)(a) and 19C(4) in deducting the interest from his receipts in arriving at the assessable profits or deducting the interest from his assessable profits.

Mr Milne has made two very significant concessions during the course of argument before this Court. First, if the disputed interest had not been capitalised in the accounts of Secan for 1988, 1989 and 1990, it could have been properly deducted pursuant to s 16(1)(a) from the assessable profits in 1991. Second, the disputed interest, despite being capitalised in the accounts, is an expenditure of a revenue nature and not a capital expenditure. These two concessions support the application of s 19C(4) to enable Secan to deduct the disputed interest from its assessable profits in 1991. Further, Mr Milne accepts that for the purposes of tax computation, the disputed interest could legitimately be shown in the accounts for 1988, 1989 and 1990 as a loss, not disputing that such accounts would have equally been in accordance with sound commercial accounting principles prevailing at the time as the capitalisation of the disputed interest was. Notwithstanding, Mr Milne argues that once the disputed interest was capitalised in Secan's accounts, Secan is somehow estopped from treating it as a loss to reduce the assessable profits for any subsequent year of

assessment. For this proposition, he relies on *Johnston v Britannia Airways*. I am, however, unable to understand how that authority, as correctly summarised by the Judge in the part of his judgment cited above, supports the proposition. Nor am I persuaded that any such estoppel has arisen in the circumstances of this case.

For the above reasons, I would dismiss the appeal.

(Gerald Godfrey) Vice-President	(Anthony Rogers) Justice of Appeal	(K.H. Woo) Justice of Appeal

Mr John Gardiner, QC and Mr John J.E. Swaine, instructed by Messrs Woo, Kwan Lee & Lo, for the Appellants (Respondents) in both appeals

Mr David Milne, QC, instructed by the Department of Justice and Miss Jenny Fung, SGC of the Department of Justice, for the Respondents (Appellants) in both appeals