IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION

COURT OF FIRST INSTANCE

INLAND REVENUE APPEAL NOS. 3 AND 4 OF 1998

HCIA3/98

BETWEEN

SECAN LIMITED — Appellant

and

COMMISSIONER OF INLAND REVENUE — Respondent

AND

HCIA4/98

BETWEEN

RANON LIMITED — Appellant

and

COMMISSIONER OF INLAND REVENUE — Respondent

Coram : Hon Mr Justice Cheung in Court

Dates of hearing : 16th, 17th and 18th November 1998

Date of handing down judgment : 27th November 1998

JUDGMENT

The Appeal

These are two appeals, by way of case stated, by two taxpayers, namely Secan Limited ("Secan") and Ranon Limited ("Ranon") against the decision of the Board of Review ("the Board"). The Board affirmed the decision of the Commissioner of Inland Revenue ("The Commissioner") which disallowed Secan and Ranon's deduction of interest paid by them in their tax computation.

The Agreed Facts

The issues in these two appeals are identical and the parties have concentrated on the facts in the appeal of Secan. The facts that were agreed by the parties for the Board are as follows. I have excluded from the Agreed Facts the appendices referred thereto.

1. Secan Limited ("Secan") was incorporated on 20th November 1987 under the *Hong Kong Companies Ordinance*. At all relevant times, Secan was and is ultimately beneficially owned by the following companies :-

	% of shareholding
Hutchison Whampoa Limited	50
Cheung Kong (Holdings) Limited	30
Hong Kong Electric Holdings Limited	20
	100

At all relevant times, the nature of Secan's business, as described in its Report of Directors attached to its accounts, was "property development and investment".

2. By an agreement dated 28th January 1988 Secan acquired an interest in a substantial piece of land at Ap Lei Chau for the purposes of redevelopment. Secan's intention in respect of the redevelopment was recorded in resolutions of its directors dated 28th January, 1988.

3. The development carried out on the land was of a large housing and commercial complex known as "South Horizons" which was completed — and the occupation permit granted by phases as follows :-

	Date
Phase 1 Podium Levels 1-3, G/F and Towers 1-5	22nd November 1991
Phase 1 Tower 6	31st March 1992
Phase 2 Podium Levels 1 and 2, G/F and Towers 7-13	30th October 1992
West Commercial Block	12th February 1993
Phase 2 Podium Levels 1 and 2, G/F and Towers 13A, 15 and 16	27th July 1993
Phase 3 Stage 1 Podium Levels 1 and 2, G/F and Towers 17, 18 and 21	20th December 1993
Phase 3 Stage 2 Podium Levels 1 and 2, G/F and Towers 19, 20, 22, 23 and 23A	2nd February 1994
East Commercial Centre	17th February 1994
Phase 4 Basements 1 and 2, G/F, Upper G/F, Towers 20-31 and Podium Deck	19th December 1994
Phase 4 Towers 25-28, 32-33A and Podium Deck	28th March 1995

Although Secan's board resolution of 28th January, 1988 referred to both development for resale of residential units and development for rental of commercial portions for long term investment, the latter only comprised a very small proportion of the overall development and in the event the only parts retained by Secan were the residential car parking and the kindergartens. The commercial area and one kindergarten were respectively sold and treated as sold in 1992, the proceeds of sale being brought into account for profits tax purposes.

4. The totality of the South Horizons development was developed for sale or sold (and liability to profits tax accepted thereon) save for the residential car parking and kindergartens referred to, which amounted in value to less than 2.3% of the development.

5. In consequence of the terms of the agreement dated 28th January, 1988 Secan was obliged to incur expenditure of HK$2,343,483,688 for the acquisition of its land at Ap Lei Chau. This was made up of payments as follows :

Shell Hong Kong Limited	$846,032,282
Hong Kong United Dockyards Limited	$293,260,334
Swire Pacific Limited	$144,603,141
Hongkong Electric Co. Ltd.	$360,000,000
Hong Kong Government	$623,300,000
	$2,267,195,757
Stamp duty and professional charges	$76,287,931
Total acquisition cost	$2,343,483,688

The above expenditure and development costs were financed by way of loans at interest from both banks and the ultimate shareholders or related companies as follows :

(a) Bank Loans

(i) From the Hong Kong Bank in the total amount of $2,600m in two tranches, tranche A for $1,600m taken out in October 1988 and tranche B for $1,000m taken out in June 1990. The interest rate was HIBOR + 0.25%.

Repayments of the above were made as to $1,600m in December 1992 and as to $1,000m in September 1994.

(ii) In September 1994 a term loan facility for $1,000m was taken out from Sakura Bank (to replace the like amount repaid to the Hong Kong Bank on the same day). The interest rate was again HIBOR − 0.25%.

(b) Shareholders / related companies loans

The remainder of the financing required was borrowed from shareholders at interest, the rate being prime rate.

6. The amounts of interest payable by Secan on the loans referred to in paragraph 5 above for the periods relevant to the present dispute were as follows :

Period 20th November 1987 to 31st December 1988	$130,607,084
Year to 31st December 1989	$250,484,062

Year to 31st December 1990		$274,725,465
Year to 31st December 1991		$209,832,059
	Total	$865,648,670

In addition to the interest referred to above loan arranging fees as follows were incurred :

Year to 31st December 1990	$7,102,117
Year to 31st December 1991	$918,509
Total up to 31st December 1991	$8,020,626

The total financing costs up to 31st December 1991 were, therefore :

Interest payable per above		$865,648,670
Loan arranging fees		$8,020,626
	Total	$873,669,296

7. Secan approved accounts for the period from 20th November 1987 to 31st December 1988, the year to 31st December 1989 and the year to 31st December 1990 which included in the balance sheets, inter alia, the following items :

	31/12/88 $	31/12/89 $	31/12/90 $
Assets			
Property under development	2,408,540,480	2,776,640,404	3,480,840,161
Liabilities			
Long term bank loan	1,600,000,000	1,600,000,000	2,600,000,000
Due to related companies	640,000,000	895,969,498	708,228,720

Due to ultimate shareholder	160,000,000	223,992,374	-

8. Included in the amounts shown as part of the cost of "Property under development" in the balance sheets were, inter alia, the following amounts of interest and financing charges :

	31/12/88 $	31/12/89 $	31/12/90 $
Bank loan interest	25,622,267	186,896,923	380,706,509
Other loan interest	104,984,817	194,194,223	275,110,102
Financing charges	-	-	7,102,117
	130,607,084	381,091,146	662,918,728

9. The profit and loss account for the period to 31st December 1988 showed a loss for the period of $31,300 as computed in the detailed profit and loss account. In respect of the loss for the period, Note (3) to the accounts is as follows :

"Loss for the period is arrived at after charging :

Auditors' remuneration	$16,000
Directors' remuneration	
- fee	-
- others	-"

10. The profit and loss account for the year to 31st December 1989 showed a loss for the year of $20,270 as computed in the detailed profit and loss account. In respect of the Loss before Taxation, Note (3) to the accounts is as follows :

"Loss before taxation is arrived at after charging :

Auditors' remuneration	$16,000
Directors' remuneration	
- fee	-
- other emoluments	-

Interest on bank loan, overdraft and other loans wholly repayable within five years	$250,484,062
Less : Amount capitalised to property under development	($250,484,062)"

11. The profit and loss account for the year to 31st December 1990 showed a profit for the year of $552,564 as computed in the detailed profit and loss account. In respect of the Profit before Taxation, Note (3) to the accounts is as follows :

"Profit before taxation is arrived at after charging interest on bank loan, overdraft and other loans wholly repayable within five years	$274,725,465
Less : Amount capitalised to property under development	($274,725,465)
Auditors' remuneration	$18,000
Directors' remuneration	
- fee	-
- other emoluments	- "

12. The profit / losses before taxation referred to above are derived from the detailed profit and loss accounts submitted with the tax computations. No amounts were included within those detailed profit and loss accounts for those years in respect of or representing the "Property under Development" or the cost thereof.

13. For the 1988/89 and 1989/90 years of assessment Secan, in its tax computations, showed losses of $26,300 and $20,270. For the 1990/91 year of assessment Secan, in its tax computation, showed assessable profits of $505,994 after setting-off of the losses brought forward. The receipts giving rise to this assessable profit (after the deduction of expenditure and losses) were derived mainly from interest receivable on purchasers' deposits on forward sales of uncompleted units and transfer fees in the developments. These losses and profits for the respective years were agreed by the Assessor.

14. Secan's balance sheet as at 31st December 1991 included, inter alia, the following :

Properties under development		$4,264,891,160
Fixed assets	$18,670,017	

Less : depreciation	$43,014	$18,627,003
Properties for sale		$6,726,111

In November 1991 the occupation permit in respect of the completion of part of Phase I of the development was issued. In consequence of that Secan brought into its profit and loss account the profit on that part of the completed development which had been held for sale and sold (see paragraph 15 below). As regards that part of the completed development which had not been sold, two new headings were created in the balance sheet ("fixed assets" and "properties for sale", as above) to which were transferred, from the heading "properties under development" the cost of the completed assets intended to be retained for rental (the residential carparking) (see Note (6) to the accounts) and the completed but as yet unsold property for sale — the kindergarten. The balance sheet as at 31st December 1991 indicated that the cost of Properties under development to date of the South Horizons project was $4,264,891,160 (including interest and loan arranging fees of $809,961,654) but excluding attributable cost of $866,167,886 of that part which had been sold in the year, of $6,726,111 of that part which was pending sale and of $18,670,017 which had been capitalised under fixed assets.

15. The profit and loss account for the year to 31st December 1991 showed a profit before taxation for the year of $1,066,230,873. The detailed profit and loss account for that year is set out at Schedule 2 of the tax computation. In consequence of the issuance of the occupation permit in the year in respect of a part of Phase I of the development an amount in respect of the profit on the sale thereof was brought into account as follows :

Profit from sales of flats		$910,358,773

The above amount being computed as follows :

Proceeds of sale		$1,802,948,787
Less		
Costs of sales, being		
Land and development cost	$802,962,340	
Financing cost	$63,205,546	$866,167,886
Selling expense		$26,422,128
		$892,590,014

Profit	$910,358,773

The above total figure of cost of sales (excluding selling expense) was calculated as being the appropriate proportion (for the property sold) of the total cumulative carried forward figure of the cost of properties under development.

16. The total cost of sales of $892,590,014 referred to in paragraph 15 above, taken into account in computing profit in the profit and loss account included a part of the total financing cost equal to $63,205,546. Consequently that amount was taken into account as a deduction in computing the profits recognised in the profit and loss account for the year to 31st December 1991. The cost of sales (including the amount of interest and loan arranging fees of $63,205,546 but excluding selling expense of $26,422,128) was $866,167,886. This amount had been deducted from the cumulative figure of cost for the properties under development of $5,156,455,174. That figure, together with the figures of $18,670,017 (fixed assets) and $6,726,111 (properties for sale) referred to above had been transferred out of the total figure of $5,156,455,174 in respect of properties under development. In consequence the latter (i.e. properties under development) as at 31st December 1991 stood at a figure of $4,264,891,160. Split between land and development and financing costs that figure (as at 31st December 1991) was made up as follows :

Land and development cost	$3,454,929,506
Financing (1)	$809,961,654

(as regards the financing costs see Schedule 6 to the 1991/92 tax computation). Included within the cost of properties for sale was a financing cost of $502,096 (2). The total of (1) and (2) above is $810,463,750. This figure together with the financing cost taken into account in computing the cost of completed flats sold in 1991 ($63,205,546) is equal to the total amount of interest and finance charges in the years 1988, 1989, 1990 and 1991 which were, respectively, as follows :

Period to 31st December 1988	$130,607,084
Year to 31st December, 1989	$250,484,062
Year to 31st December, 1990	$281,827,582
Year to 31st December, 1991	$210,750,568
Total	$873,669,296

17. Prior to submitting its tax computation for the year of assessment 1991/92 Secan had made no claim for the deduction of interest whatever; nor had any amount of interest been deducted in computing the profit appearing in its profit and loss account.

18. In submitting its profits tax computation for the year of assessment 1991/92 Secan took as its starting point the figure of profit appearing in its profit and loss account ($1,066,230,873). As set out in paragraphs 15 and 16 above that figure had been arrived at by, inter alia, deducting the sum of $63,205,546 as the financing cost of the cost of sales. No other financing costs had been deducted.

19. As indicated in paragraphs 15 and 16 above the total financing cost incurred by Secan up to 31st December 1991 had been $873,669,296.

20. In its 1991/92 tax computation Secan claimed as a deduction financing expenses incurred by it to 31st December 1991 of $810,463,750. This amount together with the figure of $63,205,546 already deducted represented the total amount of interest and financing costs paid for the purposes of the development as set out above. This represented a claim for the then current year and a carry forward of the losses represented by such interest payments in the previous years.

21. The Assessor did not accept the profits as returned by Secan and on 19th October 1992 he raised on it the following assessment :

Assessable profits per computation but before deducting financing expenses	$1,063,344,435
Tax Payable thereon	$175,451,831

In effect the Assessor simply disallowed the whole of the claim to deduct the financing charges of $810,463,750 and the sole question in this case is Secan's right to deduct the same as financing charges payable in 1991/92 or earlier years and carried forward to be set off against the profits of 1991/92.

22. Secan objected the assessment.

23. The Commissioner rejected the said objection and determined the assessment for the year of assessment 1991/92 dated 19th October 1992 showing Net Assessable Profits of $1,063,344,435 with tax payable thereon of $175,451,831.

The Agreed Issues and Decision of the Board

The two issues agreed between the parties are :

(a) 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 ("the 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. **The Board found that the interest had already been deducted.**

(b) Second Issue : if so, whether the Appellant is entitled to re-open the accounts for those years. **The Board found that it was not entitled to.**

Other agreements

It is also agreed between the parties that :

(a) if s.16(2) of the *Ordinance* applies, either condition (c) or (d) is satisfied;

(b) the overwhelming part of the property was being developed for sale (as opposed to retention) [see Paragraph 4 of the Agreed Facts]; in consequence the interest attributable to such part could not be regarded as being of a capital nature, disallowable under s.17(1)(c); and

(c) in so far as any difference in treatment should be held to apply to the interest attributable to parts of the development intended for retention the parties should be left to agree the amounts of interest so attributable.

Additional finding of fact

The Board made an additional finding of fact as follows :

"As accepted by Mr Fong Hup, we further find that paragraph 17 (of the Agreed Facts) should read :

> 'Prior to submitting its tax computation for the year of assessment 1991/92 Secan had made no claim for the deduction of interest whatever; nor had any amount of interest been deducted (other than that matched by an equivalent contra entry for interest capitalised) in computing the profit appearing in its profit and loss account.'"

The Board's Reasons for Decision

The Board's reasons for decision are as follows :

"(a) At the conclusion of arguments, it is clear that the accountancy evidence has only limited relevance to the first issue agreed between the parties. It is common ground that the Appellant had adopted the accounting treatment of capitalization of interest. The issue is whether the interest in question has already been deducted for the purpose of s.16 in the process of capitalization.

(b) We reject the submissions of the Appellant that the Ordinance lays down a statutory code for the ascertainment of assessable profit. We accept the Revenue's contentions that the first instance judgment of Hunter J. in **Lo & Lo** makes it clear that our system is analogous to the U.K. system. It is necessary to compute the true profits or gains of the taxpayer in the year in question and to have regard to ordinary commercial principles in deciding how the profits are to be ascertained.

(c) The accounts of the Appellants in capitalising interest were approved by their directors. Its auditors were of the view that those accounts 'give a true and fair view' of the state of the Appellants' affairs for the relevant periods. Retrospectively expensing interest and producing thereby for the first time substantial losses for the periods in question calls for explanation from their directors to justify how such treatment can be said to present a fair and true view of the companies' affairs in the light of their previous approvals. Given his awareness of the options in either capitalising or expensing interest, we are not persuaded by the evidence of Mr Canning Fok that such retrospective treatment accords with what the directors of the Appellants regarded at the material times as the fair and true view of the Appellants' affairs.

(d) As explained by Lord Nolan in **Gallagher v. Jones**, as a matter of legal analysis, the practice adopted by the Appellants in capitalising interest involves the deduction of the whole of the interest 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. This analysis makes it clear that the interest in question was deducted for the purpose of s.16(1) in computing the true profit of the Appellants in accordance with ordinary commercial principles."

Case stated

Secan required the Board to state a case under s.69(1) of the *Ordinance* on the following questions of law :

(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 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?

The question of law for my determination is whether in the light of the contentions of Secan as set out above, the decision of the Board pertaining to the two agreed issues is correct or incorrect.

Basis of deduction

The statutory basis for Secan to seek deduction of the interest and financial fees ("the interest") is pursuant to s.16(1)(a) and s.19C(4) of the *Ordinance*. Section 16(1)(a) provides that :

"16. Ascertainment of chargeable profits

(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;"

Secan seeks to deduct the interest in the periods in which the interest was payable and as Secan did not have profits in the first three years, the deduction gives rise to losses carried forward under s.19C(4) of the Ordinance which provides that :

"(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."

The consequence is that the whole of the interest paid for the years ending 31st December 1988, 1989, 1990 and 1991 amounting to $873,669,296 is deducted from what would otherwise be taxable profits in the year of assessment 1991/92. The basis of deduction is not challenged by the Commissioner.

Hong Kong cases on s.16

The parties referred to a number of Hong Kong cases on s.16. They do not directly touch on the issue that I have to determine but for completeness, I will set out these cases. In **Commissioner of Inland Revenue v. Mutual Investment Co. Ltd.** [1967] AC 587, the Privy Council held that

1) Section 16 (and s.s.17 and 26(A)), are part of the provision by the Ordinance for the process of ascertaining or computing the sum upon which the amount of profits tax payable by a company in a year of assessment will be calculated.

2) Section 16(1) does not provide for the deduction of expenses from the assessable profits but for the deduction of expenses "for the purposes of" the ascertainment of assessable profits. Its terms presuppose receipts from which deductions can be made to determine a balance which will be the assessable profit.

3) Section 16 (and s.18) provides exclusively for the items which may be deducted from receipts when ascertaining the assessable profit.

In **Lo & Lo v. Commissioner of Inland Revenue** 2 HKTC 34, the Privy Council held that under s.16, deductions are not confined to sums actually paid by the taxpayer but also where the taxpayer had an accrued liability for that sum.

In **Commissioner of Inland Revenue v. National Mutual Centre (HK) Ltd.** [1997] HKRC 90-086 and [1988] HKRC 90-094, the Court of Appeal construed how an interest was treated as payable by the taxpayer.

<u>Accountancy treatment of interest</u>

The accountancy evidence is that interest may either be **expensed** or **capitalised**. In relation to expensing interest it means charging it to the profit and loss account in the year in which the interest incurred. The interest is deducted from the profit for that year. In relation to capitalising the interest, it means including it as part of the carrying cost of the property under development. If the interest is capitalised, it will not constitute an immediate charge in the profit and loss account but will be brought into account on the completion of the development, in computing profits therefrom by way of deduction as part of the cost of property sold. The accountancy evidence is that either of these methods of treating interest is acceptable. This is the evidence of Secan which is accepted by the Board. The Board further found that the prevalent if not the universal practice of publicly listed property companies in Hong Kong was to capitalise interest. This is because this method produces results which accord with their commercial objective. The rationale behind this is that publicly listed companies do not wish to have huge losses appearing in their financial statements because of the payment of interest when no flats have yet been sold.

Was interest already deducted?

The issue to be determined is whether Secan had already deducted the interest totalling $873,669,296 paid by it for the purpose of financing its developments at South Horizons in the years ending 31st December 1988, 1989, 1990 and 1991. It is clear that until the year of assessment 1991/92, Secan had not claimed deduction of the interest or actually made a deduction. This is clear from the agreed facts. However, the Commissioner of Inland Revenue stated that because of the way the interest was treated by Secan in their financial statements, the interest had already been deducted. To understand this, I will set out the Commissioner's reasoning as contained in its determination of 7th January 1994.

"III. REASONS THEREFOR

(1) In the present case the Company's (i.e. Secan's) only contention is that interest incurred by it during the years 1988 to 1991 is allowable, as a taxation deduction, in the year 1991/92 by virtue of section 16(1) of the Inland Revenue Ordinance. This is notwithstanding the facts that the Company has, in its own accounts, chosen to follow accepted accountancy principles by 'capitalizing' interest expenses until the point at which the properties it is developing are sold, and that the Company has, in its tax computations for the years prior to 1991/92, followed such accepted accountancy principles.

(2) In my view the Company is missing the essential issue in concentrating exclusively on the issue of section 16. Nowhere has it considered the question of the status of the land (and the development occurring thereon) in terms of it being the Company's 'trading stock' or 'work in progress'.

(3) There is copious authority in both the U.K. and other jurisdictions that land can be trading stock - **London Investment & Mortgage Co. Ltd. v Worthington** [1958] 2 ALL ER 230; **Orchard Parks Ltd. v Pogson** [1964] 42 TC 442; and **Snell v Rosser, Thomas & Co. Ltd.** [1968] 1 ALL ER 600 are some of the examples. And on the facts of the case presently before me I would have no hesitation at all in concluding that the property known as South Horizons was at all material times, the Company's trading stock.

(4) Nor do I think that the Company would seriously contest the view that in computing profits, for the purposes of section 14, trading stock on hand both at the beginning and end of each basis period must be taken into account. This principle was established long ago and it was referred to in **Whimster & Co. v**

Commissioners of Inland Revenue (12 TC 813) where the Lord President (Clyde) stated –

> ' 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.'

In **Duple Motor Bodies Ltd. v Ostime** (39 TC 537) Lord Reid said, at P569 —

> ' It appears that at one time it was common to take no account of the stock-in-trade or work in progress for Income Tax purposes; but long ago it became customary to take account of stock-in-trade, and for a simple reason. If the amount of stock-in-trade has increased materially during the year, then in effect sums which would have gone to swell the year's profits are represented at the end of the year's profits are represented at the end of the year by tangible assets, the extra stock-in-trade which they have been spent to buy; and similar reasoning will apply if the amount of stock-in-trade has decreased. So to omit the stock-in-trade would give a false result. It then follows that some account must be taken of work in progress.'

Again, at P.571, 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.'

(5) The Company's trading stock is included in its balance sheet under the heading of 'Property under development'. The accounts also explicitly show that it is valued at cost, an acceptable method of valuation for accountancy purposes. Although not explicitly shown in the Company's 'Detailed Profit & Loss' accounts it is implicit that trading stock has been taken into account in computing profits, in the normal commercial way as follows —

Opening 'Stock'	X
add :	
Addition cost	Y
Closing 'Stock'	X+Y

(6) In this case in computing in cost of trading stock it seems correct (and this is confirmed by the Company's own accountancy treatment) that the building expenditure and the relevant interest have been correctly included. In **FC of T v St Huberts Island** (8 ATR 452) Aickin J states, at page 474 —

> ' If one were to carry the analogy of manufactured goods into the realm of real estate, it would require that land which was purchased as trading stock might, when work is done upon its development, be brought into account at the end of the year, if still retained, either at cost (which would include cost of all work done in it) or at market value under the English system, or at cost, market value, or replacement cost under ss 28-31.'

(7) In the years during which development proceeded, but prior to sales, it is patently clear that the computation of profits in paragraph (5) above will result in a 'Nil' figure. It is just as clear, in my view, that the interest incurred and which section 16(1)(a) permits as a statutory deduction has been taken into account in the "trading stock" computation for the purposes of computing profits/losses in each year. To suggest that it is additionally allowable under section 16(1) seems to me to be a clear duplication.

(8) Furthermore the Company's arguments, to be logical and consistent, must be that the whole costs of the development (and not just interest) would be

allowable under section 16(1), as and when incurred. I cannot accept that as being correct.

(9) Further and alternative to the above views, it is doubtful whether any cost included in the trading stock figure at the end of an accounting period can be said to be 'outgoings and expenses ... incurred ... in the production of profits' in terms of sections 16(1) and 16(1)(a) as an asset exists at that point in time.

(10) All in all I would hold that the assessment has been correctly computed under the provisions of the Inland Revenue Ordinance. The objection fails and the assessment is hereby confirmed."

Commissioner's reasoning flawed

The Commissioner's view is that the interest incurred each year was already included in the value of the stock in trade of Secan which had been taken into account in computing the profits / loss of Secan in each year. This is simply incorrect. For the year ending 31st December 1988, the interest paid by Secan was HK$130,607,084. In the profit and loss account for the same period, the turnover was HK$1,000 and there was an accounting loss of $31,300. The adjusted loss under s.19C(4) was HK$26,300 for the year of assessment 1988/1989. Thus, the interest paid in that year had not been taken into account in arriving at the profit / loss of that year.

For the year ending 31st December 1989, the interest paid was $250,484,082. The turnover for that year was S1,000 and there was an accounting loss of $20,270. The tax loss for the year of assessment 1989/90 was also $20,270. Again the interest had not been deducted.

For the year ended 31st December 1991, the interest paid was $281,827,582. The turnover was $572,229 and there was an accounting profit of $552,564. The interest was again not deducted.

The loss and profits for these years were accepted by the Commissioner.

Section 14 of the *Ordinance* provides that profits tax are charged to assessable profits. It is, of course, necessary to ascertain the profit of Secan for tax purpose. But 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.

Mr Fong Hup

Mr Fong Hup, the senior partner of the firm of accountants which audited the accounts of Secan stated in his evidence that :

"(1) As is set out above, in accordance with Secan's accounting policy of not recognising sales until completion, nothing in respect of the cost of property will appear in Secan's profit and loss account prior to their completion. Instead the assets are simply included in the balance sheet until the occupation permit is issued. It is only when a sale is recognised that there is a need to bring the related cost of such stock into the profit and loss account in order to determine the profit. Provided you can identify the cost of sales there is no need to bring in any general figure for the opening and closing value of stock into the profit and loss account. No such figures had been brought in by Secan in any of the relevant years.

(2) Consequently in computing the profits for the year ended 31st December 1991, there was deducted from sales a figure for the cost of stock sold and that cost included an amount of interest expenses incurred. This was done for the reasons set out above i.e. simply to ascertain the profit on the sale recognised during that year. It in fact entailed a financing charge as part of the cost of sales in the sum of HK$63,205,546 (see paragraph 15 of the Statement of Agreed Facts). No other financing costs have been charged or deducted. The amount of financing costs claimed to be deducted in the 1991/92 tax computation of HK$810,463,750 (representing financing costs of that year and earlier years carried forward) had never been charged elsewhere in Secan's profit and loss account or tax computation in that year or before.

(3) It follows from the above that there is no 'duplicate' deduction being sought in relation to the financing costs. The claim is only in relation to the timing at which the financing costs qualify for deduction.

(4) It seems to me that what the Commissioner is saying is either incorrect or in any event irrelevant. It is irrelevant because Secan has been able to identify the attributable costs of each unit sold for the purpose of determining the cost of sale of property. It is also incorrect as a matter of fact to suggest that the financing costs of HK$810,463,750 have

somehow been deducted in the profit and loss account or tax computation prior to the claim to do so in the tax computation for the year 1991/92. Furthermore, Secan's claim as I understand it, is that it is entitled in law to a deduction for the financing cost payable by it in and for each year of assessment. That is all that it is claiming with effect from 1991/92, including the carry forward of past such unrelieved payments. The position can be illustrated by comparing to a company which had not capitalised interest but had taken a straight deduction for the same each year in its profit and loss account. Secan's claim is that, in law, it is entitled to such treatment for tax purposes."

Mr Nicholas Etches

Mr Nicholas Etches, a Chartered Accountant, also confirmed that the cost of sale can be arrived at by either calculating the cost directly attributable to the items sold or deducing the amount by valuing the closing stock and attributing any decrease in the closing stock compared to the opening stock (after having taken into account costs incurred in that period) to the items sold in the period. In this case, the interest capitalised was included under the heading of "Properties under Development" in the balance sheet. When the property is sold, the interest capitalised will at that time, together with the land cost and cost of construction, be included in the cost of sale charged to the profit and loss account. He went on to explain why there was no deduction of the interest that had been capitalised.

"(1) Either method of calculation should arrive at the same amount charged against income in the period of the sale and, if interest was included in the opening stock balance (or was capitalised during the period prior to sale), will include an element of attributable cost relating to borrowing costs. Here, according to paragraph 15 of the Statement of Agreed Facts, an amount of $63,205,546 in respect of financing cost was included in the costs of properties sold in 1991.

(2) For the purposes of the tax computation, where an accounting treatment differs from an allowed or required tax treatment, appropriate adjustments should be made to ensure that no claim is made which results in a double deduction. An analogy would be the treatment of depreciation charges and depreciation allowances.

(3) The question then becomes 'in preparing the tax computation for Secan, have appropriate adjustments been made to ensure that no double deduction for interest expenses is claimed?'. I note from the 1991 computation (refer Appendix I) that $810,463,750 of interest expense has been claimed as an additional deduction from the accounting profit to arrive at the assessable profit. As no other adjustments to accounting profits have been made in the computation with respect to financing expenses, this adjustment can only be appropriate if the amount so claimed excludes any amount that has already been claimed through being included in the costs of sales for the year. I note from the analysis submitted to the IRD on 9th December, 1992 (refer Appendix L) that total interest costs incurred during the period in question were $873,669,296 and that $63,205,546 of interest has been excluded from the claim made (as referred to above) to ensure that no double deduction is claimed in respect of interest already included in cost of sales. I deduce therefore from this analysis that the deduction claimed of $810,463,750 relates solely to interest expenses which are, for accounting purposes, still included in the value of properties under development or held for sale in the balance sheet as 31st December, 1991 and that there is no attempt being made to claim a double deduction (firstly under cost of sales and secondly under section 16(1)) for interest paid by the company."

Mr Etches also stated how, if the deduction of the interest is allowed, the matter should be dealt with to prevent a duplication of the deduction.

"(4) In the years subsequent to 1991, to ensure that no double deduction is claimed for interest expense (and assuming the company's deduction of $810,463,750 is allowed in the 1991 computation), it would be necessary to add back to the accounting profit any amount of interest expense included in costs of sales, which had already been allowed in 1991. I have not seen any of the company's computations for the years subsequent to 1991 and am therefore unable to comment on whether appropriate adjustments were made in those years."

Mr Paul Franz Winkelmann

Mr Paul Franz Winkelmann, Chartered Accountant, also confirmed what had been said by Mr Fong Hup in regard to Ranon's accounts.

"(1) Ranon has not treated the development costs as stock in trade in arriving at profit (or loss). The development costs, including interest, have been taken directly to the balance sheet as an asset for all years.

(2) In 1990 Ranon recognised the sale of certain properties. In arriving at profit for the year, the cost of those properties, including interest, was deducted from the sale proceeds. The properties were identifiable and this was simply a means of determining the profit on sale of those properties.

(3) What the Commissioner appears to have in mind is a situation where the particular items disposed of cannot be identified (e.g. a manufacturer or dealer in identical items manufactured or acquired at different times). In such cases the actual profit on a particular sale may not be capable of identification since the precise item sold is incapable of identification. In such circumstances it is a recognised accounting technique to bring in the value of opening stock, additions and then the value of closing stock as a means of determining a figure for profit on the stock sold. As I have said, for the reasons given, that was simply not done here.

(4) It is clear from the Statement of Agreed Facts and Appendices and Mr. Fong Hup's Witness Statement that Ranon is not seeking a double deduction for any amount of interest. As can be seen from paragraph 14 of the Statement of Agreed Facts (in Ranon's case) the only amount of interest taken as a deduction in the profit and loss account was the amount ($101,592,694) in computing the profit on that recognised as sold in 1990. This amount plus the amount of $380,553,393 (see paragraph 14 of the Statement of Agreed Facts) represents the interest payable in the years up to and including 1990 on property developed for sale and no more. There is, therefore, no 'double deduction' for any amount of interest."

Accounting practices not principles of law

The accountant's evidence were not disturbed in the cross-examination. The Board in its decision had not dealt with this aspect of the evidence of these three accountants. Mr Milne, Q.C., Counsel for the Commissioner, submitted that the Board must have rejected their evidence. The question, however, is on what rational basis can such evidence be rejected. The Commissioner had certainly not called contrary evidence in this regard. The Board's conclusion that as a matter of legal analysis, the interest was already deducted in computing the true profit of Secan is simply without basis.

The Commissioner seemed to have elevated the accounting practices, such as that expenditure on stock and work in progress which is unsold at the end of the year must be brought into the profit computation on some basis of valuation e.g. cost or market value or a comparison of the opening stock with the closing stock in order to determine the cost of work, to be statutory requirements or principles of law which must be observed in every case. It must be borne in mind that these practices are no more than methods used to ascertain the profits in a given year. If in the first three years there was no income receipt by Secan because the sale would only be recognized when the flats have been completed and sold, then one really cannot see the relevance of relying on such practices. After all, Secan was not computating a profit because at that time there was no sale at all. Further, if the cost of sale can be determined by another method, the accounting practice of comparing the opening and closing stocks in arriving at the same result would only be superfluous.

What Lord President Clyde said in **Whimster** was that the profit is the difference between the receipt from the business and the expenditure laid out to earn those receipt. The example he gave of a merchant's profit and loss account of showing the value of the stock in trade at the beginning and at the end of the period entered at cost or market price was for the purpose of ascertaining the cost of sale in order to determine the profit. As Mr Fong said, provided one can identify the cost of sale, there is no need to bring in the figures of the opening and closing value of stock in the profit and loss account. It is only when sale of flat occurred, then there is a need to bring the related cost of such flats into the profit and loss account in order to determine the profit. This being the case, I just cannot see how the Commissioner can say the interest paid in the previous years had already been deducted because it was included in the stock in trade of Secan.

Further, of the interest of $873,669,296 capitalised, only $63,205,546 thereof was included in the costs of sale charged to the profit and loss account in arriving at the assessable profit for the year of assessment of 1991/92. The costs of sale was attributable to those of the flats sold. As part of the costs of sale, the $63,205,546 obviously had been deducted. But the balance of the interest of $810,463,750 (i.e. $873,669,296 less $63,205,546), was still included in the value of properties under development or held for sale in the balance sheet. It was not included as the costs of sale of the flats that were sold. If s.16(1)(a) allows the deduction, then how can it be objected on the basis that it had already been deducted somehow or somewhere in the accounts?

The Cases

I will very briefly deal with the cases referred to by the Commissioner to see why the courts there needed to state the accounting practices. Their facts are very far removed from the ones we are dealing with. In **Whimster**, the taxpayers hired ships on time charter and used them either for carriage of cargo or by sub-chartering them to other party. As at 31st December, 1920, they had a number of such vessels on time charter under charter parties the currency of which did not expire until various later dates. In making up their accounts for the year 1920 they took the view that in 1921, in consequence of a depression in shipping business which had already set in, the rates payable for vessels on time charter and the amounts receivable as freights would fall very seriously, and they accordingly debited in the case of each vessel the hire payable from 31st December, 1920, to the end of the period of its charter, and credited the amount they would have had to pay if they had entered into a fresh charter at 31st December, 1920, for the unexpired period of the existing charter. It was held that the difference between these sums was not a proper deduction in computing the profits of the accounting period ended 31st December, 1920, inasmuch as it was not a loss actually incurred in that period.

In **Duple Motor Bodies Ltd. v. Ostime** (39 TC 537), the taxpayer carried on the trade of building motor bodies and had, for a substantial period of time, used the direct cost method of ascertaining the cost of work in progress under which the cost of direct materials and labour were alone taken into account. The Revenue, however, assessed the work in progress by the on-cost method under which a proportion of indirect expenditure, i.e. factory and office expenses, etc., was added to the direct cost. The issue before the court is what was the correct method of ascertaining the cost of work in progress in order to determine the full amount of the profits or gains of the taxpayer's trade. Viscount Simonds at p.567, after referring to the Case Stated, gave the opinion that :

> " The final sentence is perhaps open to criticism, but I take it to mean that either method shows the full amount of the profits or gains of the trade, and I see no impossibility in this when I remember how elaborate and artificial are the methods of accountancy. The important thing is that the method which is in fact adopted should not violate the taxing Statute. Different results may be reached by different methods, neither of which does so."

In Gallagher v. Jones (Inspector of Taxes) [1994] Ch.107, the taxpayer entered into commercial leasing agreements with a finance company for buying three boats. The taxpayer agreed to lease a boat for the primary period of 24 months

for which the rental payments consisted of a substantial initial payment followed by 17 monthly payments and a secondary period of 21 years and an annual rent of £ 5. The taxpayer charged the initial payments and five out of the 17 monthly payments against his income. The Revenue rejected the calculation and calculated the expenses on the basis of a commercial method of accounting whereby the capital expenditure was spread over the useful lives of the boats. It was held by the Court of Appeal that :

1) the taxpayers' liability to income tax on their profits depended on the correct computation of their receipts and expenditure during the relevant accounting periods,

2) subject to any express or implied statutory rule, such profits were to be ascertained by applying current and generally accepted principles of commercial accounting,

3) the principles embodied in the relevant revenue Statements of Standard Accounting Practice were apt to determine the true profits or losses of the taxpayers' trade and no judge-made rule required those principles to be displaced,

4) accordingly, the taxpayers' trading losses for the relevant periods were to be computed in accordance with those principles and not in accordance with accounts prepared by the taxpayers, which gave a wholly misleading picture of their trading results.

In **Odeon Associated Theatres Ltd. v. Jones (H. M. Inspector of Taxes)** [1971] 48 TC 257, Buckley L.J. held that :

> "... it is right that the Court should pay regard to the ordinary principles of commercial accounting as far as possible... Nevertheless, the question (i.e. whether a particular outlay can be set against income or must be regarded as a capital outlay) remains a question of law."

Legal analysis of capitalising the interest

The Board referred to the legal analysis of Nolan L.J. (as he then was) in **Gallagher v. Jones** and held that Secan's capitalisation of the interest involved the deduction of interest but credited against them of a closing figure for unsold stock and for work in progress as a notional receipt. Nolan L.J.'s legal analysis was based on what Lord Reid said in **Duple Motor Bodies** concerning the deduction of expenditure. Lord Reid at p.753, rejected the Crown's argument that all expenditure should be

attributed to goods manufactured or partly manufactured during the year. He pointed out, relying on the **Vallambrosa** case, 5 T.C. 529, that expense might be deductible even though it led to no production during the year. He continued, at p.754 :

> " 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. You must justify what you seek to exclude in this way as being properly attributable to, and properly represented by, those articles."

Nolan L.J. at p.136 held that :

> " That is how he (i.e. Lord Reid) 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.' "

I really do not see what Nolan L.J. said can assist the Commissioner because, in the first place, you have to ascertain whether there was a deduction. If there was none, then there clearly is no legal principle that will, nonetheless, treat Secan as having made such a deduction. Furthermore, as Mr Gardiner, Q.C., Counsel for Secan, pointed out, the effect of crediting a figure for closing stock, i.e. unsold stock and work in progress, as a notional receipt is to exclude from the account the expenses (i.e. the interest) forming part of that notional receipt. The result is that those interest which had been capitalised as part of the closing stock have not been deducted at all.

Disclosure requirement

Reference was made to Note 3 of Secan's accounts for the year ending 31st December 1989 (and also for the following year) which provided that :

Interest on bank loan, overdraft and other loans wholly repayable within five years	$250,484,062
Less : Amount capitalised to property under development	($250,484,062)

This note is simply to comply with the disclosure requirement where interest was capitalised. This is not a statement that the interest had been expensed or deducted in calculating the profit for that year and then matched with a corresponding sum in the work in progress.

Mr Milne had given a few examples of how entries should appear in the profit and loss account and balance sheet and how they would affect the bringing of a true picture of profits made by a taxpayer. I do not see how they will advance the Commissioner's case in the light of what I had said.

Changing accounting basis

The Commissioner also argued that having adopted the capitalisation basis, Secan is not entitled to change that basis for tax purposes. He relied on **Johnson (Inspector of Taxes) v. Britannia Airways Ltd.** [1994] STC 763. In that case there were three alternative basis 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 the 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.

Time for deduction

The Commissioner submitted that when the whole of the development of South Horizons is completed, the full cost of the development which should reflect the interest capitalised will be allowed as a deduction in computing the assessable profits for that year. It is clear, however, by the operation of s.16(1)(a), this would in fact preclude the deduction of interest, because by then it would not be possible to bring the interest within its terms : it would not be incurred during the basis period for that year of assessment.

Deduction but counterbalanced by notional receipt?

Mr Milne also submitted that if the interest is allowed to be deducted, then there should be a counter-entry of a notional receipt representing the amount of the deduction. This submission might have been prompted by what I have said in the course of the submissions on the deduction of expenses not wholly attributable to the cost of goods sold as discussed by Lord Reid and Nolan L.J. I have not been addressed fully to whether a deduction under s.16(1)(a) is subject to what Lord Reid and Nolan L.J. said. But it seems such principle is not applicable because the effect of a contra entry is to prevent a deduction being made at all. Furthermore, if the interest was actually expensed or deducted in the first three years instead of being capitalised, there should not be a contra entry in the first place. Hence I do not consider it appropriate to adopt this approach in relation to s.16(1)(a) deduction.

Arguments on the additional finding of fact

There were some arguments whether the Board was entitled to make the additional finding on the agreed facts. In relation to the case of Ranon, it was agreed by the parties that the words in brackets in the additional finding, namely "(other than that matched by an equivalent contra entry for interest capitalised)", were part of the agreed facts and the Commissioner had overlooked the omission when the agreed facts for Secan were prepared. The additional facts, in my view, do not really affect the outcome of this case for the simple reason that both Secan and Ranon had not made an interest deduction until the time when the property was completed for sale. As Mr Fong explained in his evidence in the case of Secan, the interest was charged directly to or was debited directly to the work in progress account which was called the "development account". But in the case of Ranon, it was first debited or charged to an account called "interest paid" and from there before the accountants prepared the account, that amount was capitalised to work in progress. The difference was in the extra procedure adopted in accounting book-keeping in Ranon because the books of these two companies were handled by different accounting staff. In any event the amendment could not be made.

Conclusion

In the end I find that the Board was wrong to find the interest was already deducted or that Secan is no longer entitled to deduct the interest. The same reasoning applies to the case of Ranon as well. The four questions raised in the first part of the Case Stated are answered in the negative and I find that the Board's decision on the agreed issues is incorrect.

The parties have indicated that a small proportion of the interests may in any event not be deductible because they were of capital rather than of revenue nature. I have not been fully addressed on this matter. This is something the parties have to adjust accordingly.

I will further order costs nisi of the appeal to Secan and Ranon.

(P. Cheung)
Judge of the Court of First Instance,
High Court

Mr John Gardiner, Q.C., leading Mr John Swaine Jr., inst'd by
M/s Woo, Kwan, Lee & Lo, for the Appellants

Mr David Milne, Q.C., leading Ms Jenny Fung, S.G.C., of Department
of Justice, for the Respondent