Case No. D21/15

Profits tax – whether overburden removal costs were capital in nature – accounting principle 'matching concept' – sections 16, 17 and 19C(4) of the Inland Revenue Ordinance

Panel: Albert T da Rosa, Jr. (chairman), Chan Yue Chow and Lo Pui Yin.

Dates of hearing: 13 March, 10, 11 and 13 December 2012.
Date of decision: 31 December 2015.

The Taxpayer is a private limited company in Hong Kong in the business of quarrying and the sale of quarry products. The Taxpayer entered into a contract with the Government of the Hong Kong SAR to conduct civil engineering works for rehabilitation of Quarry F. The Assessor was of the view that the overburden removal costs ('the Costs') were capital in nature and not allowable for deduction in ascertaining the assessable profits. The Taxpayer appealed and argued that the Costs were of a recurring nature since they had to be incurred in each of the years of assessment in question. The Taxpayer further argued that it relied on the 'Framework of the Preparation and Presentation of Financial Statements' issued by the HKICPA and the generally accepted accounting principles especially the fundamental accounting principle called the 'matching concept'.

Held:

1. It is not disputed that in deciding whether expenditure is capital or revenue in nature, the Board should have regard to (i) the fixed/circulating capital test, (ii) the once and for all/recurring expenditure test, (iii) the enduring benefit test, and (iv) the profit yielding structure test. The Board finds that while the accounting treatment of the taxpayer might have followed the accounting standards, such treatment is not certain enough one way or the other to determine the nature of the Costs for tax purposes.

2. The Board agrees with the Respondent's submission that while the Costs were incurred in each of the years of assessment in question, that was not because the taxpayer had to go back and remove overburden in areas where it had already been removed; nor was it because overburden was sandwiched within the rock so that it had to be continuously removed as rock was extracted. Rather, the Costs were incurred over a long period of time because the Quarry spanned a very large area and so it took a considerable length of time (a few years) to remove all the overburden; and as a matter of practicality, the overburden was removed bit by bit as rock extraction progressed across the Quarry, rather than all in one go, because it was

necessary to accommodate the overburden once it was removed and it could not simply be dumped into the drop cut – due to the Taxpayer's rehabilitation obligations under the Rehabilitation Contract, the backfilling had to be engineered to ensure that the resulting piece of land would be stable and safe. The point is that once overburden had been removed in any particular spot in the Quarry, the process of overburden removal was completed for that particular spot, and no further Costs had to be incurred in respect of that spot. The fact that overburden had to be removed in many parts of the Quarry is very different from having to remove overburden repeatedly in the same part of the Quarry. The Board finds that the Costs are of capital nature.

Appeal dismissed.

Cases referred to:

Wharf Properties Ltd v CIR [1995] 1 HKLR 347
Nice Cheer Investment Ltd v Commissioner of Inland Revenue (2013) 16 HKCFAR 632
Kreglinger v New Patagonia Meat and Cold Storage Co Ltd [1914] AC 25
Amalgamated Jambad Syndicate [1979] 117 ITR 698
Commissioner of Income-Tax v Katras Jharia Coal Co Ltd [1979] 118 ITR 6
Johns-Manville Canada Inc v The Queen [1985] 2 SCR 46
Mount Isa Mines Ltd v The Commissioner of Taxation of the Commonwealth of Australia (1992) 176 CLR 141
British Insulated and Helsby Cables Ltd v Atherton [1926] AC 205

Steven Rudolf Sieker, Travis Benjamin and Enoch Wan of Messrs Baker & McKenzie for the Appellant.
Yvonne Cheng, Counsel, instructed by Department of Justice for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This is the appeal by, Company A ('the Appellant'), from the determination ('the Determination') of the Deputy Commissioner of Inland Revenue ('the CIR') dated 28 April 2011, against the assessment for profits tax for the 5 years of assessment 2002/03 to 2007/08 as confirmed by the Determination.

Ordinance Provisions

2. Section 16 of the Inland Revenue Ordinance Chapter 112 (the 'Ordinance') 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) … (h) …*'. (our emphasis)

3. Section 17 of the Ordinance provides as follows:

> '*(1) For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part **no deduction** shall be allowed in respect of- (Amended 36 of 1955 s. 25; 49 of 1956 s. 13)*
>
> *(a) domestic or private expenses, including- …*
>
> *(b) …*
>
> *(c) any **expenditure of a capital nature** or any loss or withdrawal of capital;*
>
> *(d) … (l) …*'
> (our emphasis)

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

> '*(4) Subject to section 19CB, where in any year of assessment 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 … **for that year of assessment** and to the extent not so set off, shall be **carried forward and set off** against the corporation's … assessable profits … **for subsequent years** of assessment.*' (our emphasis)

Primary Facts

5. At the hearing the parties agreed to the agreed facts as set out in the Statement of Agreed Facts exhibited in the **Annexure I** hereto. We find as facts the agreed facts set out in the Statement of Agreed Facts. Terms defined in the Statement of Agreed Facts are adopted herein unless otherwise stated.

6. The Appellant called two witnesses

6.1. Mr B, an Occupation C who worked for the Company between 1996 and 2001 and who worked for an affiliate of the Company between 2001 and 2004; and

6.2. Mr D, the current Position E of the group of companies of which the Company is one.

7. The two witnesses were tendered as factual witnesses and not as expert witnesses.

The Issues

8. The Assessor was of the view that the overburden removal costs (the 'Costs') were capital in nature and not allowable for deduction in ascertaining the assessable profits.

9. The Appellant's basic contentions as set out in paragraph 7 of the Agreed Facts are:

9.1. The Appellant should be entitled to deduct the Costs of $31,519,096, $13,440,664, $445,194, $173,372 and $17,289 for profits tax purposes for the respective years of assessment from 2002/03 to 2006/07. These Costs were revenue in nature and were incurred in the production of the Company's assessable profits for the relevant years. Accordingly, these Costs should be deductible under section 16(1) of the Ordinance.

9.2. The Appellant should be entitled to offset its accumulated tax loss brought forward from the year of assessment 2001/02 in the amount of $152,019,441 against its assessable profits for the years of assessment 2002/03 to 2006/07 under section 19C(4) of the Ordinance.

Capital or Revenue in Nature

10. The general principles which are to be applied in determining whether an expense is capital or revenue in nature are set out by Patrick Chan J (as he then was) in Wharf Properties Ltd v CIR [1995] 1 HKLR 347 ('Wharf Properties')

10.1. At line 23 on page 374:

'*In some of the previous decisions cited to me, the expenditure in question was clearly of a capital nature while in other cases, it was clearly of a revenue nature. However, there were borderline cases where it would be difficult to come to any firm conclusion one way or another. I do not propose to go into each of these cases or try to follow or distinguish any of their decisions. They turned on their respective facts and the different governing statutes. Several tests had been suggested in*

these authorities. None of these tests is decisive. The courts had placed greater reliance on one test in a particular set of circumstances and on another in a different set of circumstances. At the end of the day, the answer to this vexed question depends very much on the facts of each case. (See the comments of Stark J. in Hallstrom Pry Limited v. Federal Commissioner of Tax [1946] 72 CLR 634 at 644). It seems that ultimately it is "a common sense appreciation of all the guiding features" which would provide the answer (see Lord Pearce in B.D. Australia Limited v. Federal Commissioner of Tax (1965) 112 CLR 386).' [1]

10.2. At line 35 on page 347 of the judgment, Patrick Chan J described as most 'enlightening' the following quoted the comments of Lord Pearce at page 397 of the B P Australia Limited v Federal Commissioner of Tax case:

'The solution to the problem is not to be found by any rigid test or description. It has to be derived ***from many aspects [Emphasis added by this board]*** *of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a common sense appreciation of all the guiding features which must provide the ultimate answer. Although the categories of capital and income expenditure are distinct and easily ascertainable in obvious cases that lie far from the boundary, the line of distinction is often hard to draw in borderline cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. That answer "depends on* ***what the expenditure is calculated to effect from a practical and business point of view rather than upon a juristic classification of the legal rights****, if any, secured, employed or exhausted in the process." (per Dixon J. in Hallstrom's case 72 CLR 634 at 648). As each new case comes to be argued, felicitous phrases from earlier judgments are used in argument by one side or the other. But those phrases are not the deciding factor, nor are they of unlimited application. They merely crystallize particular factors which may incline the scale in a particular case after a balance of all the considerations has been taken.'* ***[Original emphasis by Patrick Chan J in underlined italics. The board's own emphasis in bold]***

[1] The correct citation of this Privy Council case is B P Australia Limited v Federal Commissioner of Taxation (1965) 112 CLR 386, PC. We have also referred to Lord Pearce's judgment for the Privy Council in that case to correct some typographical errors in the quoted passage in paragraph 10.2 herein below.

11. Patrick Chan J then went on to deal with the following more important and common tests, which he treated as relevant factors, namely (i) The fixed/circulating capital test, (ii) The once and for all/recurring expenditure test, (iii) The enduring benefit test, and (iv) The profit yielding structure test.

12. It is not disputed that in deciding whether expenditure is capital or revenue in nature, the Board should have regard to those principles and factors set out above.

Evidence Of Mr B On Nature Of Overburden

13. Mr B was tendered as a factual witness. In his statement we were informed:

13.1. In quarry terms, overburden is weathered rock and soil of low value. It has some limited uses, such as in the manufacture of bricks, for road base, as a filling material in reclamation and where a landform needs to be built up (collectively, 'Overburden').

13.2. Mines and quarries are fundamentally different operations.

13.3. A mine can be defined as the extraction site of metals and solid fossil fuels. Mines can be underground or above ground. The three main types of mine are:

(a) Underground mines: it is usual to construct shafts downwards from the surface and then branch out in a horizontal direction. The vertical shaft is usually in the country rock, that is, the barren or low grade rock formation that surrounds a mineral deposit. The horizontal passageways or drifts provide access for personnel and equipment from the vertical shaft to the place where extraction can commence.

(b) Open pit mines: also referred to as open cut or opencast mines: are employed to exploit mineral deposits in any rock type lying on or near the surface. A photograph of an open pit gold mine in [City F], China, is attached hereto and marked 'PF2'; and

(c) Strip mines: the term applied mainly to the mining of near surface coal seams. Most strip mines involve bedded sedimentary formations.

13.4. In each of the underground, open pit/open cut/opencast and strip mining, it is necessary for the operator to **win access** to the ore body (minerals). The operator has to remove the overburden and **make a 'first cut'** through the layers of rock and other weathered materials to get at the target minerals. **That is to say the operator must cut through rock and weathered materials to access the minerals**.

13.5. Once the minerals in an open/pit cut/opencast mine have been reached, the mining operation consists of subsequent cuts into overburden (in mining terms) to access the minerals. Waste material is dumped in the void created by the previous cut. The process of **subsequent cuts** to access the minerals **occurs over and over again** in operation of the mine, for the life of mine.

13.6. A quarry is commonly defined as an excavation or system of excavations made for the purpose of, or in connection with, the extraction of rock (for example, granite, limestone, rock with an aesthetic appearance to be used for floor tiles and curtain walling) for aggregates and industrial minerals. A quarry is above ground. As with open pit/open cut/opencast and strip mining, the operator has to make a 'first cut' but it is shallower and narrower than in open pit/open cut/opencast and strip mining. (our emphasis)

13.7. [The Appellant] was not required to make, and has never made, a 'first cut' at [Quarry G] to win access to fresh rock for aggregate production.

13.8. To the extent that a 'first cut' was made at [Quarry G], it was made well before [the Appellant] took over the operation of [Quarry G].

13.9. [The Appellant] was required to remove Overburden to gain access to the fresh rock for aggregate production, and to use where possible the Overburden for bricks and blocks and other end uses.

13.10. [The Appellant] was required to continuously remove Overburden in the operation of [Quarry G].

14. To illustrate his points, Mr B referred the Board to :

14.1. Drawing No. XXXX/XX/XXX (**'the Birdseye View Plan'** and exhibited hereto as Annexure II*) showing various lines for preparing cross-section plans including the line for the cross-section N-N; and

14.2. Drawing No. XXXX/XX/XXX (**'the Section N-N Plan'** and exhibited hereto as Annexure III**) which shows:

* The Annexure II in this published version has been adjusted to suit the size of the publication and is therefore not to scale and various matters which may identify the location and identities of the parties have been redacted.

** The Annexure III in this published version has been adjusted to suit the size of the publication and is therefore not to scale and various matters which may identify the location and identities of the parties have been redacted.

(a) a vertical axis denoting elevation from 100 metres above the principal datum to 450 metres above the principal datum;

(b) a horizontal axis denoting distance (at the elevation level of 100 metres from the principal datum) extending from left to right for a length of 650 metres;

(c) a point of origin at elevation of 100 metres above the principal datum and 0 metres of distance;

(d) various lines denoting the silhouette of a hill – with the highest point at about 360 - 380 metres about the principal datum, including:

(i) a dotted line at the top running the full length of the 600 metres on the left at the point about the 50 metre mark of the horizontal line and sloping down to the right (which in the Legend to the Section N-N Plan is described as 'initial lines and level survey') which shows the original ground surface ('the Initial Lines and Levels Survey Line' or 'the First Line');

(ii) a second dotted line under the Ground Surface Line running from the 50 metre mark to 220 metre or 240 metre mark (which in the Legend to the Section N-N Plan is described as 'Soil / Rock Interface') which shows the level of the transition between the overburden and the quarry ('the Soil/ Rock Interface Line' or 'the Second Line');

(iii) a solid line running the full length of the 600 metres (which in the Legend to the Section N-N Plan is described as 'proposed final land form') ('the Final Land form Line' or the 'Third Line');

(e) the intersection of the First Line and the Third line at about 340 metres ('the Intersection Point')

15. In his evidence Mr B also said:

15.1. 'At p.325 of Bundle A6, at clause 9.2, it is required that the Rehabilitated Slope, being a part of the Final Landform, be "stable, safe and maintenance free" in relation to all the types of slopes. At p.302 of Bundle A6, its is also required that during the excavation process, the quarry faces must be maintained in a "safe positions", and the face

angles and heights must be planned such that the Quarry can be worked "in a safe and efficient manner".'

15.2. 'The Overburden had to be removed in stages, to allow excavation of the rock in stages, in order that slopes were safe both during the quarrying process, and once the Final Landform was achieved.'

15.3. 'Thus, a parallel can be drawn to the Johns-Manville case, which would strongly suggest that the Overburden removal cost is a revenue expense.'

16. The last point is certainly an opinion on a matter which is for this Board to decide.

Evidence of Mr D on Accounting Treatment

17. Mr D was also tendered as a factual witness. In his statement, the Board was informed:

17.1. In para 9 that 'In setting [the Appellant's] accounting policy, including the policy in respect of overburden expenses, I relied on the 'Framework of the Preparation and Presentation of Financial Statements' issued by the HKICPA ('the Framework') and the generally accepted accounting principles especially the fundamental accounting principle called the 'matching concept' to give a true and fair view of [the Appellant's] state of affairs and its profits and cash flows.'

17.2. In para 10 that '[the Appellant's] accounting policy in respect of overburden expenses, over the years of assessment in dispute was to amortize the relevant costs for accounting purposes and report the same as deferred expenditure. … This approach is adopted on the principle that expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process is commonly referred to as "matching concept".'

Accounting Treatment

Nice Cheer CFA

18. The Court of Final Appeal handed down its judgment in Nice Cheer Investment Ltd v Commissioner of Inland Revenue (2013) 16 HKCFAR 632 on 12 November 2013. Although this Appeal was heard earlier, we called for written submissions from the parties on the implication(s) (if any) of this judgment on their positions. Having considered the written submissions, we consider that the following passages in the CFA judgment are pertinent:

‘ 9. *There is no dispute that the Respondent’s financial statements for the relevant accounting periods were prepared in accordance with the prevailing albeit new accounting practice in Hong Kong. The Respondent accepts (and its auditors reported) that its financial statements were prepared in accordance with accounting principles generally accepted in Hong Kong and showed a true and fair view of its affairs and of its profits and losses for the relevant accounting periods. But it contends that its profit and loss accounts need to be adjusted for tax purposes by excluding unrealised profits from its tax computations since they are not assessable to profits tax. ….*

13. *The question for decision, therefore, is whether for the purpose of profits tax unrealised increases in the value of trading stock held at the end of the accounting period as a result of the revaluation should be included in the computation of “the full amount of the profits ... arising in or derived from Hong Kong during the year[s] of assessment”. As the Courts below observed, this raises a matter of statutory construction, not accounting practice. The question is one of law: what does the statute mean by the words “the full amount of the profits therefrom during the year of assessment”?….*

14. *At the heart of the Commissioner’s case lay three propositions. First, the word “profits” is not defined in the Ordinance, and in the natural and ordinary meaning of the word unrealised profits are nonetheless profits. Secondly, the amount of the profits during the year of assessment is primarily a question of fact. And thirdly, the amount of any profits or losses during the year of assessment must be ascertained by reference to ordinary principles of commercial accounting unless these are contrary to an express statutory provision in the Ordinance. These principles are not static but so long as they remain current and generally accepted they provide the surest guide to the question that the legislation requires to be answered ...*

The role of the principles of commercial accounting

33. *The Commissioner submitted that the amount of any profits or losses during the year of assessment must be ascertained by reference to the ordinary principles of commercial accounting unless these are contrary to an express statutory provision in the Ordinance, and relied on the decision of this Court in Commissioner of Inland Revenue v Secan Ltd for this purpose. That is a misreading of my judgment in that case. After citing the celebrated passage in the judgment of Sir John Pennycuick VC in Odeon Associated Theatres Limited v Jones, in which he explained the relationship between accountancy evidence and the ascertainment of the taxpayer’s assessable profits, I said:*

> *"Both profits and losses therefore must be ascertained in accordance with the ordinary principles of commercial accounting as modified to conform with the Ordinance. Where the taxpayer's financial statements are correctly drawn in accordance with the ordinary principles of commercial accounting and in conformity with the Ordinance, no further modifications are required or permitted."*

It should be noted that I said "in conformity with the Ordinance", not "in conformity with an express provision of the Ordinance".

34. *It is a fundamental principle of the constitution of Hong Kong, as of England, Australia, the United States and other democratic societies, that the subject is to be taxed by the legislature and not by the courts, and that <u>it is the responsibility of the courts to determine the meaning of legislation. This is not a responsibility which can be delegated to accountants, however eminent.</u> This does not mean that the generally accepted principles of commercial accounting are irrelevant, but their assistance is limited.*

35. *In the present case the subject matter of the tax is "profit", and the question what constitutes a taxable profit is a question of law. While the amount of that profit must be computed and ascertained in accordance with the ordinary principles of commercial accounting, these are always subject to the overriding requirement of conformity, not merely with the express words of the statute, but with the way in which they have been judicially interpreted. Even where the question is a question of computation, the court must "always have the last word" …*

Financial Statements

44. *<u>It must be borne in mind that the new accountancy standards are directed to the preparation of financial statements and not tax computations, and that the two serve different purposes.</u> Financial statements are prepared in order to give investors, potential investors, financial advisers, and the financial markets generally a true and fair view of the state of affairs of the company and in particular its financial position and profitability. Those who read them are concerned not with the past but with the future, and in particular the future profitability of the company. <u>The Ordinance, however, is directed to the past. The Commissioner is not concerned with the likelihood that the taxpayer will make profits in future but whether it made them in the past.</u>*

45. The courts have had frequent occasion to comment that while a taxpayer's financial accounts, drawn in accordance with ordinary principles of commercial accountancy, may be appropriate for the purpose of showing its financial position they may not be appropriate for the assessment of tax. Where they are not appropriate for this purpose, the taxpayer is entitled or may be required to adjust them for tax purposes:

46. In Willingale v International Commercial Bank, where the taxpayer's financial statements were found to be drawn up in a way which anticipated future profits, Lord Fraser said that there were no doubt excellent commercial reasons for preparing the accounts in that way and borrowed the words of Walton J that they

> *"are much better economic indicators than corporation tax accounts would be as to whether a bank is or is not doing what it ought to be doing, that is to say, steadily making an economic profit for its shareholders."*

Despite this he held that they were not a proper basis for assessing the bank's liability to tax.

………

The new accounting standards

48. The new accounting standards have been adopted internationally by many different countries including the United Kingdom. Their purpose, eminently laudable, is to harmonise so far as possible the preparation of financial statements so that they may be understood by those who read them and who live in a global world. They are not intended, and cannot sensibly be thought to have been intended, to harmonise the tax liabilities of taxpayers carrying on businesses in countries with greatly different tax regimes. The international nature of the new accounting standards militates against their use for tax purposes.

49. As the Respondent observed in its printed case, the existence of mandatory international accounting standards for the preparation of financial statements provides surer evidence than was available in the past of the ordinary principles of commercial accounting, but they cannot take the place of the Ordinance as interpreted by the courts.' [Emphasis added by underlining]

Appellant's Position

19. The Appellant complained that at the hearing, the Commissioner put forward the position that the adoption of such accounting treatment was evidence of the underlying facts relevant to the determination of the legal question. Put another way, while it was conceded that accounting standards did not mandate tax treatment, the suggestion was that the accounting treatment adopted by the taxpayer was evidence of the taxpayer's true view of the overburden removal expenditure.

20. As for any inference that the adoption of commercial accounting decision is somehow evidence relevant to the tax position of the Appellant, the Appellant submitted in its post hearing written submissions that this argument was also rejected by the Court of Final Appeal in Nice Cheer, where the Court made it clear that commercial accounting standards have entirely different concerns and purposes from the provisions of the Inland Revenue Ordinance and therefore can be of only limited relevance in determining a liability to tax.

21. The Appellant further asserts that it had 'no choice but to amortise the Costs'.

Respondent's Position

22. The Respondent says where the evidence about the Appellant's accounting treatment came in was in relation to the fact that the Costs created an advantage for the enduring benefit of the Appellant's business. Clearing the overburden enabled the Appellant to enjoy rock extraction for many years. The Appellant was able to extract rock and sell rock products long after the overburden removal was finished. Whilst the Appellant claimed at the appeal that the removal of overburden did not create an enduring advantage, this was not its view at the time, as demonstrated by its accounting treatment of the Costs, which was based on the management's view that the economic benefits of the Costs lasted not only for the year in which they were incurred, but throughout the life of the Quarry.

23. In other words, the Respondent's argument was *inter alia* that the accounting treatment was relevant in showing that the Appellant itself felt that the Costs (of overburden removal) lasted beyond the accounting year, and had an enduring benefit for the life of the 16-year contract.

24. The Respondent submitted in the Respondent's closing submission paragraph 40, whether the Costs were capital for tax purposes and met the test of enduring benefit is a question of law for the Board to decide (and not a question of accounting). Relevant to that question was the fact that the benefit of overburden removal would last beyond the year in which it took place. That fact in turn was demonstrated by various pieces of evidence, which were summarized in the Respondent's closing submissions, such as:

24.1. the fact that whilst the overburden removal was substantially completed by January 2004, the Appellant continued to enjoy the benefits therefrom by continuing to extract rock up to the present day;

24.2. the fact that the overburden removal took place within a short period at the beginning of the contract;

24.3. the Appellant's choice to capitalize the Costs, treat them as a non-current asset in the balance sheet, and then deduct an amortised portion each year, rather than to treat them as an expense as and when they arose;

24.4. Mr B's oral evidence to the Board that the Costs did in fact give rise to a benefit over the entire life of the Quarry, hence the choice of accounting treatment in spreading out the Costs over the length of the contract.

25. The Board finds that while the accounting treatment of the Appellant might have followed the accounting standards, such treatment is not certain enough one way or the other to determine the nature of the Costs for tax purposes.

Approach Regarding Authorities

26. Apart from the treatment reflected in the accounts the Board was also referred to the treatment of overburdens in other court cases.

27. It is not disputed that in deciding whether an expenditure is capital or revenue in nature, the Board should have regard to:

27.1. whether the expenditure was incurred once and for all;

27.2. whether the expenditure brought an asset or advantage for the enduring benefit of the business;

27.3. whether the expenditure was on the profit-yielding subject, or on its operations.

28. The Appellant submitted that whether the removal of overburden was a capital expense or a current expense was an issue that had been considered in the common law world on a number of occasions and took us to a number of these 'overburden cases'.

29. The Respondent submitted that question should be determined by reference to the principles in the authorities, and not by broad analogy to the facts of previous cases. The Respondent referred us to the following passage in Kreglinger v New Patagonia Meat and Cold Storage Co Ltd [1914] AC 25 (House of Lords) at page 40.

> ' *But when a previous case has not laid down any new principle but has merely decided that a particular set of facts illustrates an existing rule; there are few more fertile sources of fallacy than to search in it for what is simply resemblance in circumstances, and to erect a previous decision into a governing precedent merely on this account*'.

30. Their Lordships in Kreglinger went on to say at page 40:

> ‘ *The consideration of cases which turn on particular facts may often be useful for edification, but it can rarely yield authoritative guidance.*’

31. The Board finds the cases cited useful for edification but nothing more.

What The Other ‘Overburden Cases’ Say

32. The Board was referred to a number of Commonwealth cases and both parties tried to draw parallels of the present situation with the facts and circumstances in those cases.

Amalgamated Jambad Syndicate (11 July 1975 Calcutta High Court)

33. In Amalgamated Jambad Syndicate [1979] 117 ITR 698, it was said at page 704:

> ‘*It has been found as a fact that the removal of overburden and the winning of coal were both continuous processes and were being carried on simultaneously from year to year. The removal of overburden cannot be compared to the opening of a new pit. Once a pit is opened the same confers a permanent benefit on the mine and can be used for winning coal at different seams and for the purpose of reaching new seams.* ***The overburden resting on the surface of a particular area, if removed, could enable the company only to reach the coal under that and not any further. If any further surface had to be exposed, further overburden had to be removed.*** *It appears to us that if the expenditure is made for acquiring or bringing into existence an asset or advantage for the enduring benefit of the business it is properly attributable to capital and is of the nature of capital expenditure. On the other hand, if such an expenditure is made not for the purpose of bringing into existence any such asset or advantage but for running the business or working it with a view to produce profits it is a revenue expenditure. The above distinction has been made in the decision of the Supreme Court in the case of Assam Bengal Cement Co Ltd v. CIT [1955] 27 ITR 34 at page 45. The Supreme Court further went on to observe that if the aim and object of the expenditure would determine the character of the expenditure then the source or the manner of the payment or the test of fixed or circulating capital would not arise.*’ [Emphasis added]

34. Relying on the last sentence in the first passage cited in paragraph 33 herein the Appellant submitted that the taxpayer in Amalgamated Jambad Syndicate operated an open quarry coal mine (which was said to be similar to the Quarry in the present case) and the court found the removal of the overburden was a continuous process carried on from year to year. Thus, the Appellant submitted the passage that follows (setting out the

principle for determining whether expenses were deductible) is equally applicable to Hong Kong.

35. The Respondent referred us to the third paragraph of the judgement at page 700 (summarised in second sentence in the second line in the headnote) which says:

> ‘ *Removal of overburden on the surface of the coal area is a continuous process and likely to increase from year to year on account of incline seam being deeper with advancement of mining operations*’.

36. The Respondent submitted:

36.1. that it tells us that as a matter of fact it was a very different sort of mine because with this mine the overburden got more and more as time went on because **as one went deeper and deeper there was more and more waste material**; and

36.2. that it is exactly the opposite in the present Quarry in Hong Kong because as time went on the overburden got less and less because it was removed and that was it, there would not be any more embedded within the rock.

Katras Jharia Coal Co. Ltd (15 September 1978 Calcutta High Court)

37. In Commissioner of Income-Tax v Katras Jharia Coal Co Ltd [1979] 118 ITR 6, it was said at page 10:

> ‘ ***In the instant case, the expenses incurred in removing the overburden were not for acquiring any right of property either on the land or on the product but were incurred in the course of winning coal from an open-case mine.*** *The question is whether this is revenue expenditure or an expenditure capital in nature.* ***It has been found as a fact that the expenditure has not brought about any enduring benefit to the assessee.*** *The contentions of the assessee in this behalf before the AAC and the Tribunal were* ***at no time controverted nor were sought to be denied on behalf of the revenue. The findings were based on the admitted statements of the assesse,*** *believed by the Tribunal: vide Gouri Prasad Bagaria v. CIT [1961] 42 ITR 112(SC). Accordingly, we were not inclined to take a view different from that taken in Amalgamated Jambad Syndicate Pvt Ltd. [1979] 117 ITR 698 (Cal).*
>
> Mr. *Pal for the assessee had drawn our attention to another decision of the Supreme Court in CIT v. Kirkend Coal Co. [1970] 77 ITR 530, where it was held that the expenditure incurred by a colliery company in stowing operations was revenue expenditure and was eligible for deduction inasmuch as such operations were necessary in the process of extraction of coal and, without which, extraction would not be possible. It appears to us that the contentions*

> *of the assessee also find support from this decision of the Supreme Court.*' [Emphasis added]

38. The Appellant submitted that in Katras Jharia Coal Co Ltd the Indian courts once again found that the expenses incurred in removing the overburden and, as in the present case, there was no enduring benefit to the Appellant.

39. The Respondent submitted that Katras Jharia Coal Co Ltd concerns a coal mine and '[i]t has been found as a fact that the expenditure has not brought about any enduring benefit to the assessee.' And by that stage they were on appeal already so the court was no longer investigating the evidence, they were simply proceeding on the findings of fact as found at First Instance. 'We were not concerned with the quantum or the quality of the evidence,'

Johns-Manville Canada Inc (1985)

40. In the Canadian Supreme Court case of Johns-Manville Canada Inc v The Queen [1985] 2 SCR 46 a similar question arose, albeit in relation to the expense to acquire land adjacent to a huge open pit mine. The Appellant submitted as follows:

40.1. There, the evidence was that this land would be used so as to establish a safe slope for the continuing operation of the mine.

40.2. The court reviewed the leading cases on the determination of whether an expense was revenue or capital in nature from around the world, including Australia, the United Kingdom and the United States and held:

> '*The assessment of the evidence and the conclusions to be derived therefrom, and the application of the common sense approach to the business of the taxpayer in relation to the tax provisions, leads, in my respectful view, to the conclusion that the mining operations here approximate the circumstances encountered in the traditional open pit mining more than underground mining and so I conclude, with all respect to those who have otherwise concluded, that the appropriate taxation treatment is to allocate these expenditures to the revenue account and not to capital.*'

40.3. The court went on to say:

> '*Common sense dictated that these expenditures be made, otherwise the taxpayer's operations would, of necessity, be closed down. These expenditures were not part of a plan for the assembly of assets. Nor did they have any semblance of a once and for all acquisition.*'

41. The Canadian legislation is set out at page 55 of Johns-Manville:

‘ *This proceeding concerns only s.12(1) of the Income Tax Act, R.S.C. 1952, c.148, which provided as follows:*

12. (1) In computing income, no deduction shall be made in respect of

(a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,

(b) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of deprecation, obsolescence or depletion except as expressly permitted by this Part, ...’

42. The Respondent submitted that in the Canadian case it was said at page 72 of the report that ‘*The characterisation in taxation law of an expenditure is, in the final analysis (unless the statute is explicit which this one is not), one of policy.*’ However, in Hong Kong it is a matter of ‘law’: see the Wharf Properties and the Nice Cheer CFA judgment.

Mount Isa Mines Ltd v FC of T (1992)

43. The Respondent cited Mount Isa Mines Ltd v The Commissioner of Taxation of the Commonwealth of Australia (1992) 176 CLR 141 (the ‘Mount Isa Mines Case’) and submitted that there did not need to be a physical asset that was created; it sufficed if there was some advantage created for the benefit of the business. See the Mount Isa Mines Case at its headnote and pages 150-151, 152, where the cost of demolishing an obsolete structure was held to be capital in nature, because it conferred a positive and enduring advantage on the premises.

44. The Appellant submitted the following:

44.1. In the Mount Isa Mines Case, the taxpayer constructed a sloping tunnel, described as a decline, through which equipment could be driven for the purpose of access to the area from which the ore was extracted, i.e., the stopes, and to remove the ore from the stopes to the surface of the mine. The decline was extended from time to time as the ore was extracted and comprised relatively straight lengths and a number of sharp bends that established a type of zigzag as the decline extended to greater depths below the surface of the land. The decline was roughly parallel to the ore body but some 20 to 30 metres from it. The decline was approximately 5 metres square.

44.2. The Full Federal Court in Mount Isa Mines Case held that the cost of constructing the extension of the decline during the particular tax year before the court was a revenue expense. The court found that the usefulness of a particular extension of the decline, as a means of obtaining the ore in the immediate vicinity, lasted only for a short time. It was influenced by statements made in Morant v Wheal Grenville Mining Co (1894) 3 TC 298 that the costs of sinking shallow pits to get minerals which are the source of profits for that particular year are revenue expenses.

British Insulated and Helsby Cables Ltd v Atherton (1926)

45. The Appellant referred to British Insulated and Helsby Cables Ltd v Atherton [1926] AC 205, where it was said at page 213:

> ‘ *Now, in Vallambrosa Rubber Co. v. Farmer Lord Dunedin, as Lord President of the Court of Session, expressed the opinion that "in a rough way" it was "not a bad criterion of what is capital expenditure - as against what is income expenditure - to say that capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur every year"; and no doubt this is often a material consideration. But the criterion suggested is not, and was obviously not intended by Lord Dunedin to be, a decisive one in every case; for it is easy to imagine many cases in which a payment, though made "once and for all," would be properly chargeable against the receipts for the year.*’

46. The Respondent submitted that if the item of expenditure was paid with a view to bringing into existence an asset or an advantage for the enduring benefit of the business, then the expenditure ought to be classified as capital and not revenue in nature. See Wharf Properties at page 376 lines 17-28, where Patrick Chan J cited British Insulated and Helsby Cables Ltd v Atherton [2] at page 213:

> ‘ *But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital. For this view there is already considerable authority.*’

Administrative Treatments in Other Jurisdictions

47. In support of the contention that removal or overburden is of revenue nature, the Appellant also referred us to the administrative guidelines in other jurisdictions on treatment of overburden.

---

[2] [1926] AC 205

48. However, the legislative regime behind each of the jurisdictions from which the administrative guidelines were issued were not the same as that in Hong Kong. Further, the types of mine and/or quarry are different from the quarry in question. The Board does not find those guidelines relevant or of assistance.

Nature of the Costs

49. The Appellant argued that the Costs were of a recurring nature, since they had to be incurred in each of the years of assessment in question.

50. The Board agrees with the Respondent's submission that while the Costs were incurred in each of the years of assessment in question, that was not because the Appellant had to go back and remove overburden in areas where it had already been removed; nor was it because overburden was sandwiched within the rock so that it had to be continuously removed as rock was extracted. Rather, we find the Costs were incurred over a long period of time because:

50.1. the Quarry spanned a very large area and so it took a considerable length of time (a few years) to remove all the overburden;

50.2. as a matter of practicality, the overburden was removed bit by bit as rock extraction progressed across the Quarry, rather than all in one go, because it was necessary to accommodate the overburden once it was removed and it could not simply be dumped into the drop cut – due to the Appellant's rehabilitation obligations under the Rehabilitation Contract, the backfilling had to be engineered to ensure that the resulting piece of land would be stable and safe;

51. The Board also agrees with what the Respondent submitted in paragraph 26 of the Respondent's closing submissions:

' *The point is that once overburden had been removed in any particular spot in the Quarry, the process of overburden removal was completed for that particular spot, and no further Costs had to be incurred in respect of that spot.* ***The fact that overburden had to be removed in many parts of the Quarry is very different from having to remove overburden repeatedly in the same part of the Quarry****. To take an analogy: for example, a large factory which manufactures garments may require the installation of hundreds of sewing machines, but the fact that the installation process has to be carried out hundreds of times does not thereby render the installation cost a "recurring" one – once each machine is installed, it is ready to be used to generate profit, and it does not need to be installed again. A recurring cost would be, for example, the cost of oiling each machine from time to time – it is a process which is repeated over and over with the same machine in the course of the*

profit-making process. The former is a "once and for all" expense, whilst the latter is a recurring expense.' (our emphasis)

52. From the evidence of Mr B we find as follows: [Note: Annexure IV of the Decision is omitted in this published version.]

52.1. On the picture on page 18 in PF-6 referred to in his statement, and exhibited as **Annexure IV** hereto, which is a side view of the Quarry, the overburden was not the green layer but the thin layer, between the vegetation layer and the layer of solid rock;

52.2. Conceptually, in Annexure III,

(a) the area marked by the First Line and the Second Line was the area of the Overburden which the Appellant had to remove from the site;

(b) the area marked by the Second Line until it joined the First line and thereafter the First line on the one hand and the Third Line on the other hand to the left of the intersection was the area of the Quarry;

(c) the area marked by the Third Line and the First line to the right of the intersection was the area of the Drop Cut A1 area which had been evacuated before the commencement of the contract in question and which the Appellant had to fill back in accordance with the contract with the Government;

52.3. The Appellant had to remove the overburden progressively (as if one were removing rings of an onion). The Overburden was removed from a section of around 50 metres by 50 metres in area, and the rock underneath that section was quarried. After the quarrying was complete, the process would be repeated on an adjacent section of the Quarry until they reached the various levels of plateau terraces as shown by the Third Line in order to maintain a safe working environment and achieve the final landform as required by the Rehabilitation Contract.

52.4. We do not agree with Mr B's views in his witness statement at paragraphs 34 and 35. We are satisfied that the first-cut and the work described in paragraph 52.3 herein are of a capital nature and as characterised by the Respondent in paragraph 51 herein. They are part of the infrastructural works necessary to give lasting benefit to the Appellant's other continuous operations.

53. We are satisfied that the Costs are of Capital nature.

Set Off

54. At the end of the day the parties agree that the point of set-off will not affect the amount of tax in dispute. It does not affect the assessment.

55. If anything, the set-off only affects the amount of tax in subsequent years.

Disposal Of The Case

56. The Board therefore dismisses the appeal and up-holds the assessment in the Determination.

57. The Chairman deeply apologises for the time taken in his deliberation and thanks the parties for their patience.

Annexure I

INLAND REVENUE BOARD OF REVIEW
APPEAL NO. BR XX/XX

Between

COMPANY A Appellant

and

COMMISSIONER OF INLAND REVENUE Respondent

STATEMENT OF AGREED FACTS

1. Company A (formerly known as Company H) ('the Company') has objected to the Profits Tax Assessments for the years of assessment 2002/03 to 2007/08 raised on it. The Company claims that the assessments were excessive.

2. (a) The Company was incorporated as a private limited company in Hong Kong before 1997. It commenced business in 1997.

   (b) The Company was jointly set up by Company J and Company K. Its ultimate holding company was Company L.

   (c) In its tax returns for the relevant years of assessment, the Company described the nature of its principal business activity as quarrying and the sale of quarry products.

   (d) The Company originally made up its accounts to 31 March each year. For the year of assessment 1999/00, it changed its accounting date from 31 March to 31 December. Commencing from that year, the Company closed its accounts on 31 December each year.

3. In 1997, the Company entered into a contract with the Government of Hong Kong (changed to the Government of the Hong Kong Special Administrative Region on 1 July 1997) ('the Government') to conduct civil engineering works for rehabilitation of Quarry F ('the Quarry'). The contract with the Government also entitled the Company to operate the Quarry. A contract sum of $2XX million was to be paid by the Company to the Government over the life of the Quarry by semi-annual

payments. The rehabilitation was being carried out by several stages and each stage was represented by the achievement of a final landform which was geotechnically stable.

4. On divers dates, the Company filed Profits Tax returns for the years of assessment 1996/97 to 2007/08, together with the audited financial statements and Profits Tax computations.

(a) In its Profits Tax returns, the Company declared the following assessable profits or adjusted loss:

Year of assessment	Assessable profits / (Adjusted loss)	Loss carried forward (Note 1)
	$	$
1996/97	(743,374)	743,374
1997/98	(3,566,187)	4,309,561
1998/99	(103,014,783)	107,324,344
1999/00	(24,432,331)	131,756,675
2000/01	(12,166,991)	143,923,666
2001/02	(8,095,775)	152,019,441
2002/03	(7,366,357)	159,385,798
2003/04	11,199,396	148,186,402
2004/05	28,821,735	119,364,667
2005/06	2,145,737	117,218,930
2006/07	26,425,331	90,793,599
2007/08	23,357,971	991,158

Notes

1. Figures as shown in the Company's Profits Tax computations.

(b) In arriving at the adjusted loss for the years of assessment 1996/97 and 1997/98 [see Fact (4)(a) above], the Company deducted, among other items, overburden removal costs in the respective amounts of $521,533 and $3,898,250 as part of its cost of production.

(c) The Company's audited financial statements showed that, commencing from the year of assessment 1998/99, the Company reported the overburden removal costs as a non-current asset (deferred expenditure) in its balance sheet, in accordance with applicable accounting standards, and then amortised the same in its accounts.

(i) In respect of the overburden removal costs, the following costs, accumulated amortisations and net book values were reported under deferred expenditure in the notes to the balance sheets:

Year / Period ended	31-03-1999	31-12-1999	31.-12-2000	31-12-2001	31-12-2002	31-12-2003	31-12-2004	31-12-2005	31-12-2006	31-12-2007
Cost	$	$	$	$	$	$	$	$	$	$
Balance brought forward	-	22,310,357	56,712,254	97,224,065	132,620,991	164,140,087	177,580,751	178,025,945	178,199,317	178,216,606
Reinstated amount*		4,419,784	-	-	-	-	-	-	-	-
Additions	22,310,357	29,982,113	40,511,811	35,396,926	31,519,096	13,440,664	445,194	173,372	17,289	150,435
Balance carried forward (A)	22,310,357	56,712,254	97,224,065	132,620,991	164,140,087	177,580,751	178,025,945	178,199,317	178,216,606	178,367,041
Accumulated amortisation										
Balance brought forward	-	7,235,724	17,901,161	28,223,161	38,543,761	52,576,566	66,609,841	81,659,756	96,715,464	111,772,136
Reinstated amount*	-	4,419,784	-	-	-	-	-	-		
Charge for the year / period	7,235,724	6,245,653	10,322,000	10,320,600	14,032,805	14,033,275	15,049,915	15,055,708	15,056,672	15,056,670
Balance carried forward (B)	7,235,724	17,901,161	28,223,161	38,543,761	52,576,566	66,609,841	81,659,756	96,715,464	111,772,136	126,828,806
Net book value at the year / period ended [(A) - (B)]	15,074,633	38,811,093	69,000,904	94,077,230	111,563,521	110,970,910	96,366,189	81,483,853	66,444,470	51,538,235

* The notes included the following remark on 'Reinstated amount':

> '(Amounts) incurred for overburden removal prior to the amortization scheme that commenced on 1st April 1999 were reinstated in the balance sheet to facilitate the monitoring of project costs.' (i.e. overburden removal costs incurred during the years of assessment 1996/97 and 1997/98 [Fact (4)(b)])

(ii) Notes to the Company's audited financial statements set out the Company's principal accounting policy on overburden removal costs as follows:

<u>Year ended 31 March 1999 and period ended 31 December 1999</u>

Overburden removal costs are amortised over the total estimated production capacity of the Quarry site area where the removal costs are incurred and charged to the profit and loss account/statement based on the yearly production volume.

<u>Years ended 31 December 2000 to 2007</u>

Overburden removal costs are incurred to bring the Quarry site into a condition ready for excavation. They are amortised over the remaining useful lives of the Quarry and site using the straight-line method.

(d) The Company's profit and loss accounts for the period ended 31 March 1999 and years ended 31 December 1999 to 2007 showed the following:

Period / Year ended	31-03-1999	31-12-1999	31-12-2000	31-12-2001	31-12-2002	31-12-2003	31-12-2004	31-12-2005	31-12-2006	31-12-2007
	$	$	$	$	$	$	$	$	$	$
Turnover	108,289,029	83,657,788	112,325,284	119,828,754	108,682,819	116,422,376	100,704,811	95,584,120	94,740,548	104,550,289
Less: Cost of sales	103,184,414	65.848.460	103,898,905	115,208,510	105,754,225	115,071.326	99.566.516	89,968,102	89.848.550	95,845,141
Gross profit	5,104,615	17,809,328	8,426,379	4,620,244	2,928,594	1,351,050	1,138,295	5,616,018	4,891,998	8,705,148
Other income	1,953,006	199,456	2,283,450	1,982,687	1,094,304	2,222,154	2,049,562	1,728,988	2,437,119	2,011,743
	7,057,621	18,008,784	10,709,829	6,602,931	4,022,898	3,573,204	3,187,857	7,345,006	7,329,117	10,716,891
Less: Expenses	7,061,939	18,008,566	10,709,527	6,602,464	4,022,433	3,572,231	3,187,047	5,155,006	5,228,327	5,643,609
Profit/(Loss) before tax	(4.318)	218	302	467	465	973	810	2,190,000	2,100,790	5,073,282

Note

The cost of sales was computed as follows:

Year / Period ended	31-03-1999	31.-12-1999	31-12-2000	31-12-2001	31-12-2002	31-12-2003	31-12-2004	31-12-2005	31-12-2006	31-12-2007
	$	$	$	$	$	$	$	$	$	$
Opening stock	4,966,512	4,122,708	5,242,835	4,041,266	7,982,516	5,206,164*	22,143,418	28,721,002	24,208,887	23,395,033
Cost of production:										
Amortisation of overburden removal	7,235,724	6,245,653	10,322,000	10,320,600	14,032,805	14,033,275	15,049,915	15,055,708	15,056,672	15,056,670
Others	79,660,531	60,722,934	92,375,336	107,999,458	88,945,066	117,975,305	91,094,185	70,400,279	73,978,024	81,438,022
Purchase of aggregate	16,689,174	-	-	859,169	-	-	-	-	-	-
	108,551,941	71,091,295	107,940,171	123,220,493	110,960,387	137,214,744	128,287,518	114,176,989	113,243,583	119,889,725
Less:										
Transfer for capital expenditure	1,244,819	-	-	29,467	-	-	-			
Closing stock	4,122,708	5,242,835	4,041,266	7,982,516	5,206,162	22,143,418	28,721,002	24,208,887	23,395,033	24,044,584
Cost of sales	103,184,414	65,848,460	103,898,905	115,208,510	105,754,225	115,071,326	99,566,516	89,968,102	89,848,550	95,845,141

* As per the Company's computation schedule.

(e) The Company's Profits Tax computations for the years of assessment 1998/99 to 2007/08 showed that its reported assessable profits/adjusted loss [see Fact (4)(a) above] were computed as follows:

Year of assessment	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	$	$	$	$	$	$	$	$	$	$
Profit/(Loss) before tax [Fact (4)(d))	(4,318)	218	302	467	465	973	810	2,190,000	2,100,790	5,073,282
Add:										
Amortisation of overburden removal [Note to Fact (4)(d)]	7,235,724	6,245,653	10,322,000	10,320,600	14,032,805	14,033,275	15,049,915	15,055,708	15,056,672	-
Other items	12,785,438	25,728,033	31,883,306	28,664,736	19,935,329	19,848,407	19,971,771	21,474,698	36,330,601	42,482,195
	20,016,844	31,973,904	42,205,608	38,985,803	33,968,599	33,882,655	35,022,496	38,720,406	53,488,063	47,555,477
Less:										
Overburden removal costs incurred during the period / year [i.e. the additions as per Fact (4)(c)(i)]	22,310,357	29,982,113	40,511,811	35,396,926	31,519,096	13,440,664	445,194	173,372	17,289	-
Other items	100,721,270	26,424,122	13,860,788	11,684,652	9,815,860	9,242,595	5,755,567	36,401,297	27,045,443	24,197,506
Assessable profits / (Adjusted loss) [Fact (4)(a)]	(103,014,783)	(24,432,331)	(12,166,991)	(8,095,775)	(7,366,357)	11,199,396	28,821,735	2,145,737	26,425,331	23.357,971

Notes

1. The following note is included in the Company's Profits Tax computation for the year of assessment 1998/99 (similar notes are included in the Company's Profits Tax computations for the years of assessment 1999/2000 to 2006/07):

   '[The overburden removal costs] represented expenditure incurred for the removal of both granite and volcanic soil, the surplus crushed rock and debris. Since the expenses are revenue in nature and were incurred in the production of chargeable income, they are deductible under Section 16(1) of the Inland Revenue Ordinance.'

2. The following note is included in the Company's Profits Tax computation for the year of assessment 2007/08:

'[The amortisation of overburden removal] is deductible on the basis that it is revenue in nature and was incurred in the production of the Company's assessable income ... the amount charged to profit and loss account (being the amortisation amount) is treated as deductible.'

(f) At all relevant times, the Company's auditor was Company M. The reports of the auditor on the Company's financial statements for all relevant years stated that the financial statements were prepared in accordance with the Hong Kong Companies Ordinance and accounting principles generally accepted in Hong Kong or Hong Kong Financial Reporting Standards and gave a true and fair view of the Company's state of affairs and its profits and cash flows.

5. The Assessor was of the view that the overburden removal costs were capital in nature and not allowable for deduction in ascertaining the assessable profits. On divers dates, the Assessor issued the following statements of loss to the Company:

Year of assessment	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
	$	$	$	$	$	$
Assessable Profits for the year	-	-	-	5,549,782	28,344,820	27,301,151
Less: Loss set-off	-	-	-	5,549,782	28,344,820	27,301,151
Net Assessable Profits	-	-	-	0	0	0
Loss brought forward	-	221,841	0*	80,704,426	75,154,644	46,809,824
Add: Adjusted Loss for the year	221,841	0	80,704,426	-	-	-
	221,841	221,841	80,704,426	80,704,426	75,154,644	46,809,824
Less: Loss set-off	-	-	-	5,549,782	28,344,820	27,301,151
Loss carried forward	221,841	221,841*	80,704,426	75,154,644	46,809,824	19,508,673

* See Notes 2 to 4 below.

Notes

1. The assessable profits / adjusted loss for the years of assessment 1996/97 to 2001/02 were computed as follows:

Year of Assessment	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
	$	$	$	$	$	$
Loss per return	743,374	3,566,187	103,014,783	24,432,331	12,166,991	8,095,775

Year of Assessment	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
	$	$	$	$	$	$
[Fact (4)(a)]						
Less: Overburden removal costs	521,533	3,898,250	22,310,357	29,982,113	40,511,811	35,396,926
[Facts (4)(b) and (4)(e)]						
Assessable Profits / (Adjusted Loss)	(221,841)	332,063	(80,704,426)	5,549,782	28,344,820	27,301,151

2. Part of the assessable profits for the year of assessment 1997/98 was set-off by the loss carried forward for the year of assessment 1996/97, the net assessable profits for the year of assessment 1997/98 were $110,222 ($332,063 - $221,841).

3. No Profits Tax Assessment was raised on the Company for the year of assessment 1997/98 pursuant to section 60(1) of the Inland Revenue Ordinance ('the Ordinance') as more than six years had elapsed since the end of the said year of assessment.

4. In the above circumstances, there was no longer any loss to be carried forward in the year of assessment 1997/98 for set-off against the assessable profits of subsequent years of assessment.

6. On 4 December 2007, the Assessor raised on the Company the following Profits Tax Assessments:

Year of Assessment	2002/03	2003/04	2004/05	2005/06	2006/07
	$	$	$	$	$
Assessable Profits	24,152,739	24,640,060	29,266,929	2,319,109	26,442,620
Less: Loss set-off	19,508,673				
Net Assessable Profits	4,644,066				
Tax Payable thereon	743,050	4,312,010	5,121,712	405,844	4,627,458

Note
The assessable profits for the years of assessment 2002/03 to 2006/07 were computed as follows:

Year of Assessment	2002/03	2003/04	2004/05	2005/06	2006/07
Profit / (Loss) per return [Fact (4)(a)]	(7,366,357)	11,199,396	28,821,735	2,145,737	26,425,331
Add / Less: Overburden removal costs [Fact (4)(e)]	31,519,096	13,440,664	445,194	173,372	17,289
Assessable Profits	24,152,739	24,640,060	29,266,929	2,319,109	26,442,620

7. On behalf of the Company, Company M ('the Representative') objected to the above Profits Tax Assessments on the following grounds:

(a) The amounts assessed were excessive and unwarranted in fact and in law.

(b) The Company should be entitled to deduct the overburden removal costs of $31,519,096, $13,440,664, $445,194, $173,372 and $17,289 for profits tax purposes for the respective years of assessment from 2002/03 to 2006/07. These costs were revenue in nature and were incurred in the production of the Company's assessable profits for the relevant years. Accordingly, these costs should be deductible under section 16(1) of the Ordinance.

(c) The Company should be entitled to offset its accumulated tax loss brought forward from the year of assessment 2001/02 in the amount of $152,019,441 against its assessable profits for the years of assessment 2002/03 to 2006/07 under section 19C(4) of the Ordinance.

(d) The assessments were otherwise incorrect.

8. In response to the Assessor's enquiries, the Representative asserted the following:

(a) 'In the present case, the Company is engaged in the business of quarrying and sale of quarry products. The Company operated [the Quarry] at [Address N] ... The Company does not own [the Quarry]. In the course of operating [the Quarry], the Company incurred overburden expenses for removal of the surface soil and waste rock (which were of no commercial value) to expose

the stone for extraction. Such expenditures did not result in any enduring benefit nor bear any relation to any asset for the business operation of the Company.'

(b) 'The removal of overburden expenditures were incurred by the Company every year on a continuous basis and in the normal process of quarrying operation. In particular, [the Company] has advised that once the overburden has been removed in one particular area of the quarry, extraction of stone in that particular area would normally only last for a few months. The process (removal of overburden) would then be repeated in other area of [the Quarry]. As such, the expenditures were not incurred on a "once and for all basis" and did not bring any enduring benefit to the Company. In fact ... the Company incurred overburden removal expenses every year since 1996/97 (first year of operation of [the Quarry]) up till now.'

(c) '[The cases of Commissioner of Income-Tax v. Katras Jharia Coal Co. Ltd [1979] 118 ITR 6 and Johns-Manville Canada Inc v. The Queen [1985] 2 S.C.R. 46, and the Taxation Ruling TR 95/36 issued by the Australian Taxation Office] have illustrated that if expenditures (no matter in form of overburden expenses or land acquired for rimming purposes) incurred in connection with the operation of open pit mining and / or quarry mines were incurred as an integral part of the taxpayer's day-to-day operations and that they did not bring any enduring benefit to the taxpayer, such expenditures should be revenue in nature and deductible.'

(d) 'In light of the foregoing, the removal of overburden expenses should be regarded as revenue expenditures incurred in the production of the Company's assessable profits. Accordingly, the expenditures should be deductible under Section 16(1) of [the Ordinance].'

9. The Representative explained the Company's accounting policy on overburden removal costs and provided comment as follows:

(a) '[The Company] has adopted the accounting policy to amortize these costs over the remaining useful live of [the Quarry] contract using the straight-line method. In view that the remaining useful live of [the Quarry] contract was over one year, these costs are classified as non-current assets in the Company's balance sheets for the relevant years. This classification is in accordance with the 'Framework for the Preparation and Presentation of Financial Statements' issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and in line with the generally accepted accounting principles.'

(b) 'The Court of Final Appeal in the case of CIR v. Secan Ltd & Ranon Ltd, 5 HKTC 266 established the principle that the assessable profits or losses of a taxpayer must be ascertained in accordance with the ordinary

principles of commercial accounting, as modified to conform to the Ordinance. In addition, after the Secan case, your Department has in its Departmental Interpretation and Practice Notes No. 40 ("DIPN 40") expressed its view that deduction on prepaid revenue expenses would no longer be allowed and only the amount amortized or charged against profit and loss account would be allowed for claiming deduction.'

10. The 'Framework for the Preparation and Presentation of Financial Statements' issued by the HKICPA includes the following paragraphs on 'Recognition of assets':

(a) 'An asset is recognized in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.'

(b) 'An asset is not recognized in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead such a transaction results in the recognition of an expense in the income statement. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the entity or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the entity beyond the current accounting period is insufficient to warrant the recognition of an asset.'

11. Having considered the Representative's contentions and available information, the Assessor maintained that the overburden removal costs were not deductible in computing the Company's assessable profits. She was also of the view that the amount of deferred overburden removal expenditure amortised to the Company's profit and loss account for the year of assessment 2007/08 could not be allowed for deduction. Accordingly, the Assessor raised on the Company the following Profits Tax Assessment for the year of assessment 2007/08:

	$
Profits per return [Fact (4)(a)]	23,357,971
Add: Amortisation of deferred overburden removal expenditure for the year [Note to Fact (4)(d)]	15,056,670
Assessable Profits	38,414,641
Tax Payable thereon (after deducting tax rebate)	6,697,562

12. On behalf of the Company, the Representative objected to the above Profits Tax Assessment on the following grounds:

(a) The amount assessed was excessive and unwarranted in fact and in law.

(b) The Assessor had incorrectly disallowed the deduction for amortisation of overburden removal costs of $15,056,670. The Company incurred the costs in the production of its assessable profits and was therefore entitled to deduct the costs under section 16(1) of the Ordinance. Such deduction was not denied under section 17 of the Ordinance.

(c) The Company was entitled to the tax loss brought forward from the year of assessment 2006/07 in the sum of $24,349,129, which should be set-off against its assessable profits for the year of assessment 2007/08 of $23,357,971 resulting in accumulated tax loss of $991,158 for carrying forward to subsequent years of assessment.

(d) The assessment was otherwise incorrect.

13. By a letter dated 28 August 2009, the Assessor issued a statement of facts to the Representative for comment and asked the Representative to provide further information and documents concerning the Company's objections.

14. In its reply dated 29 October 2009, the Representative contended the following:

(a) 'According to the contract entered into with [the Government] [in] 1997, the Company was required to pay the Government a sum of HK$218 million for the right to sell or remove from [the Quarry] any rock or overburden excavated during the contract period. However, the Company is not entitled to any portion of the land for development. The land / [the Quarry] is at all times owned by the Government.'

(b) 'As previously mentioned, overburden expenses were incurred for removal of the surface soil and waste rock to expose the stone for extraction ... the completion date for Milestone "C" — compacted backfilling (filling of earth, soil or rock into a drop cut area (where stone was extracted from that area)) was 24 January 2004. The process of overburden removal was substantially completed prior to that date. As such, the overburden removal expenses decreased significantly since the completion of backfilling in 2004 (i.e. year of assessment 2004/05), and the Company has not incurred most of the expense items (i.e. diesel, rental expenses for excavator, truck, generator, rock breaker, soil removal & backfilling, parts and consumable and blasting of decomposed rocks) after the year of assessment 2004/05.'

15. The Company provided the following documents in its reply:

(a) A schedule showing the Company's works and responsibilities under the contract entered into with the Government.

(b) A flow chart of the Company's quarrying operation.

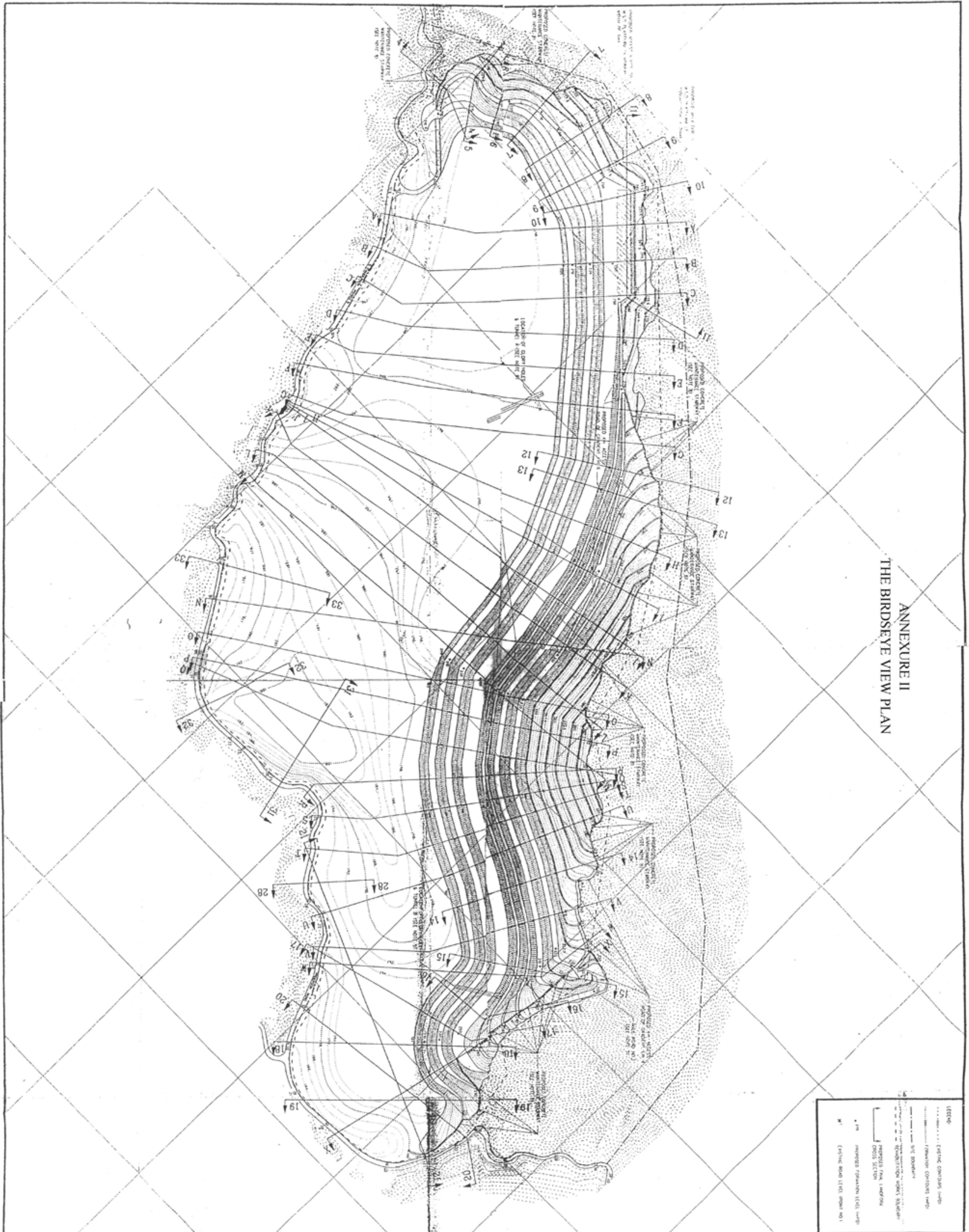
(c) A breakdown of overburden removal costs incurred in the years of assessment 1996/97 to 2007/08.

(d) A table showing the calculation of the amounts of the amortisation of deferred overburden removal expenditure charged to the Company's profit and loss accounts for the years of assessment 1998/99 to 2008/09.

10 December 2012

[(sd.) Name of Solicitors Firm]	(sd.) [Name and Rank of Government Counsel]
For the Appellant	For the Respondent

Annexure II



Annexure III