

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D103/99

Profits tax – accounting method – principle against anticipation of both income and profits – whether profit is realised when it is received or when it becomes due and payable – whether or not the instalment overdue and unpaid should be brought into account – trade debts – dividend payment.

Panel: Robert Wei Wen Nam SC (chairman), Berry Hsu Fong Chung and Kenneth Ku Shu Kay.

Dates of hearing: 15, 16, 17 and 23 June 1999.

Date of decision: 28 December 1999.

The taxpayer was incorporated in 1989 and the nature of its business as ‘acquisition and development of property’. At all material times, the taxpayer’s ultimate holding company was Company A. In the year 1990, the taxpayer acquired the contiguous old properties located at District B. It then demolished the old properties for development into a 44-storey building called Property 1.

Prior to the completion of the development of Property 1, the taxpayer pre-sold the unit there. Development of Property 1 was completed in 1996 and the occupation permit was issued on 6 February 1996. The taxpayer’s accounts for the year ended 30 June 1996 were drawn up on the full accrual basis by bringing into the profit and loss account the whole purchase price as a receipt at full value on the day of the sale. However the profits tax computation was based on the instalment method, recognizing revenue and accounting for profit on the basis of cash payments received. In the profit tax return for the year of assessment 1996/97, the taxpayer excluded the proportionate profit on sale attributable to that part of the sales revenue outstanding by purchasers as at the date of the balance sheet.

The assessor was of the view that the taxpayer’s accounting treatment in respect of the profit earned on sale of properties on an instalment basis was correct and that the tax treatment should follow the accounting treatment. The assessor therefore raised additional profits tax assessment. The taxpayer claimed that the assessment is excessive and that the assessor has incorrectly assessed the profits from the sale of properties on an instalment basis, which profit it has not earned. The Commissioner of Inland Revenue confirmed the decision and the taxpayer appealed.

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Held :

1. The choice of accounting method depends on the director's decision to reflect which economic substance in the financial statements – performance of the property developer's act or the underlying credit risk of the sale.
2. There is a principle against anticipation of both income and profits, but there is a difference between the two in terms of application of that principle. The principle with regard to income is that it is taxable only when it is received (Leigh v IRC [1928] 1 KB 73 and Dewar v IRC [1935] 2 KB 351 applied).
3. Profit is realised when it is received or when it becomes due and payable, and that it becomes taxable when it becomes due and payable (Willingale v International Commercial bank Limited [1978] AC 834, BSC Footwear Limited v Ridgway [1972] AC 544, Duple Motor Bodies Limited v IRC [1961] 1 WLR 739 and Farmers Trading Co v CIR (NZ) 11 ATR 210 applied). The instalment overdue and unpaid under the sales should be brought into account in the year in question because they are due and payable.
4. Trade debts are regarded as 'one notable exception' to the application of the principle against anticipation. Trade debts are treated on a full accrual basis (Lord Greene MR in Johnson v WS Try Limited 27 TC 167 was applied). However, future instalments payable over a long period of many years are in a different situation. The instalments, if practicable, should be valued and brought into account in the year of the sale, not at their face value, but at their actual value. If no satisfactory situation valuation is possible, then the instalments should be taxed in each year as they fall due (Absalom v Talbot 26 TC 166 applied and CIR v Montana Lands HKTC 314 distinguished).
5. The Board found that the profits from the twelve units, having been used, together with profits from the other units, to make up the dividend which was paid, cannot still be deemed to be profits to be taken out of the profit and loss account in computing profits tax (Chancery Lane Safe Deposit and Offices Co Ltd v IRC [1966] AC 85; BW Nobes & Co, Ltd v IRC [1966] 1 WLR 111 and Princes Investments Ltd v IRC [1967] 1 Ch 953 applied).

Appeal dismissed.

Cases referred to:

CIR v Montana Lands HKTC 314

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Leigh v IRC [1928] 1 KB 73
Dewar v IRC [1935] 2 KB 351
Willingale v International Commercial Bank Limited [1978] AC 834
BSC Footwear Limited v Ridgway [1972] AC 544
Duple Motor Bodies Limited v IRC [1961] 1 WLR 739
Farmers Trading Co v CIR (NZ) 11 ATR 210
Lord Greene MR in Johnson v WS Try Limited 27 TC 167
Absalom v Talbot 26 TC 166
Chancery Lane Safe Deposit and Offices Co, Ltd v IRC [1966] AC 85
BW Nobes & Co, Ltd v IRC [1966] 1 WLR 111
Princes Investments Ltd v IRC [1967] 1 Ch 953

Gladys Li SC instructed by Department of Justice for the Commissioner of Inland Revenue.
Robert Kotewall SC instructed by Woo Kwan Lee & Lo, Solicitors for the taxpayer.

Decision:

Nature of appeal

1. This is an appeal by the Taxpayer against the determination of the Commissioner of Inland Revenue (the CIR) dated 14 September 1998 whereby the CIR confirmed an additional profits tax assessment for the year of assessment 1996/97 charging additional assessable profits of \$93,723,812 with additional profits tax thereon of \$15,464,429. The basis period for the year of assessment is 1 July 1995 to 30 June 1996. The Taxpayer contends that the Commissioner was wrong in determining that the profits in question were derived during the basis period for that year of assessment.

Agreed facts

2. The parties have agreed certain facts which are set out below.
- (1) The Taxpayer has objected to the additional profits tax assessment raised on it for the year of assessment 1996/97. The Taxpayer claims that the assessment is excessive and that the assessor has incorrectly assessed the profits arising from the sale of properties on an instalment basis, which profit it has not earned.
 - (2) The Taxpayer was incorporated in Hong Kong on 25 August 1989. In its profits tax returns, it described the nature of its business as ‘acquisition and development of property’. At all material times, the Taxpayer’s ultimate holding company was Company A.

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- (3) In the year 1990 the Taxpayer acquired the contiguous old properties located at District B. It then demolished the old properties for development into a 44-storey building called Property 1.
- (4) Prior to the completion of the development of Property 1, the Taxpayer pre-sold the unit there. The purchasers of the individual units had the following options to settle the purchase consideration:

- (a) Interest-free instalments

Under this payment method, a purchaser had to pay:

- (i) 10% of the purchase price within five days of signing the provisional agreement for sale and purchase;
- (ii) a further 5% within twenty-one days of signing the provisional agreement for sale and purchase;
- (iii) a further 15% by ten interest-free monthly instalments commencing 31 March 1995; and
- (iv) the balance within fourteen days of the issue of the occupation permit.

- (b) Percentage completion

Under this payment method a purchaser had to pay:

- (i) 10% of the purchase price within five days of signing the provisional agreement for sale and purchase;
- (ii) a further 5% within twenty-one days of signing the provisional agreement for sale and purchase;
- (iii) a further 5% on 29 April 1995;
- (iv) a further 5% on 31 July 1995;
- (v) a further 5% on 21 October 1995; and
- (vi) the balance within fourteen days of the issue of the occupation

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permit.

(c) Immediate instalment payments

Under this payment method a purchaser had to pay:

- (i) 10% of the purchase price within five days of signing the provisional agreement for sale and purchase;
- (ii) a further 5% within twenty-one days of signing the provisional agreement for sale and purchase;
- (iii) the balance by a maximum of one-hundred-and-eighty monthly instalments within thirty days from the date of formal agreement for sale and purchase and the interest rate was prime plus 2.75%.

However, if a purchaser opted for this method of payment, the Taxpayer had the right to arrange for a loan from a bank or finance company for the purchaser.

(d) Immediate payment

Under this method a purchaser had to pay:

- (i) 10% of the purchase price within five days of signing the provisional agreement for sale and purchase; and
- (ii) the balance within thirty days.

- (5) Development of Property 1 was completed in 1996 and the occupation permit was issued on 6 February 1996.
- (6) In its accounts for the year ended 30 June 1996 the Taxpayer showed, among other items, the following:
- (a) Instalments receivable, \$71,170,707;
 - (b) Current assets – Instalments receivable, \$57,480,906; and
 - (c) Profit before taxation of \$524,441,154 which included a profit on property trading of \$517,221,811. The latter figure was arrived at in the following way:

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| | |
|--------------------------------|-------------------------------|
| | \$ |
| Sale of flats of Property 1 | 714,823,275 |
| <u>Less : Cost of sales</u> | <u>197,601,464</u> |
| Profit on property trading | <u><u>517,221,811</u></u> |

By way of a note to the accounts, the Taxpayer stated the following accounting policies on its recognition of revenue:

‘ Revenue arising from the development of properties for sale together with the interest earned on the instalment sales of properties are recognised upon the sale of properties or the issue of an occupation permit by the Hong Kong Government, whichever is later. Deposits and instalments received on property sold prior to the date of revenue recognition are included in the balance sheet under forward sales deposits received.’

The Taxpayer’s auditors expressed the opinion that the accounts gave a true and fair view of the state of the Taxpayer’s affairs as at 30 June 1996 and of the profit for the year then ended.

- (7) In its profits tax return for the year of assessment 1996/97 the Taxpayer excluded the following portion of the profit on property trading as ‘ unearned profits on flats sold on an instalment basis during the year’ :

$$\begin{aligned} & \text{Profit on property trading} \times \frac{\text{Instalments receivable}}{\text{Proceeds from sale of flats}} \\ &= \$517,221,811 \times \frac{71,170,707 + 57,480,906}{714,823,275} \\ &= \$93,087,932 \end{aligned}$$

The Taxpayer stated that the ‘ proportionate profit on sale attributable to that part of the sales revenue outstanding by purchasers (referred to in the accounts as “instalments receivable”) as at the date of the balance sheet was treated as unearned for profits tax purpose’ . It did not offer this portion of the profit for assessment.

- (8) Pending additional information from the Taxpayer, the assessor raised on it the following 1996/97 profits tax assessment:

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| | \$ |
| Assessable profits per return | 430,717,342 |
| <u>Less</u> : Set-off of loss brought forward | <u>635,880</u> |
| Net assessable profits | <u>430,081,462</u> |
| Tax payable thereon | <u>70,963,441</u> |

The Taxpayer did not object to this assessment.

- (9) Upon the assessor's request, the Taxpayer provided the following information in relation to its sale on an instalment basis:
- (a) It assigned the title of a flat sold on an instalment basis to the purchaser only upon full payment of the purchase price.
 - (b) It handed the flat sold over to a purchaser after the issue of the occupation permit and after either:
 - (i) the purchaser had paid the purchase price in full; or
 - (ii) the purchaser had executed a supplemental agreement to postpone completion of the sale and purchase and to agree to pay the balance of the purchase price to it by monthly instalments with interest.

As an illustration of its instalment sales, the Taxpayer provided the following documents in respect of a flat in Property 1:

- (a) Provisional agreement for sale and purchase dated 26 February 1996;
- (b) Agreement for sale and purchase dated 1 March 1996;
- (c) Supplemental letter dated 5 March 1996; and
- (d) Supplemental agreement dated 26 March 1996, which stated, inter alia, the following:

‘ WHEREAS ...

 - (c) ... the balance of the purchase price is now due and owing by the

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purchaser to the vendor. Due to failure on the part of the purchaser in obtaining finance for payment of the balance of the purchase price, the purchaser has requested the vendor to amend and vary the terms of the said agreement to the effect that the outstanding balance of purchase price in the sum of \$6,489,099 together with interest thereon shall be paid by the purchaser to the vendor by way of monthly instalments and the purchaser shall be entitled to take delivery and possession of the said premises on the signing of this supplemental agreement and that the completion of the sale and purchase of the said premises shall be postponed and the vendor has agreed so to do. Provided that the vendor shall always have right to require the purchaser to complete the purchase of the said premises at any time when financing of the outstanding balance of purchase price can be obtained from banks/financial institutions designated by the vendor.

1 ... the parties hereto agree that:

- (i) The balance of the purchase price in the sum of \$6,489,099 shall be paid together with interest thereon at the rate of 10.25 per annum subject to fluctuation and at such other rate as may be determined by the vendor in accordance with clause 9 hereof by 240 equal consecutive calendar monthly payments of \$63,699.9 each. The first instalment shall be paid on the 26th day of April 1996, the subsequent instalments to be payable on the 26th day of each successive calendar month ... [*Provided that if the purchaser shall default in payment of any of the said instalments or payments as and when it falls due, the vendor shall be entitled by notice in writing to call upon and require the purchaser to pay the whole of the balance of purchase price then outstanding immediately or within such time as may be specified in the notice (added by the Board)*].

...

- (iii) *Each monthly instalment as aforesaid shall be applied first in payment of interest then due and owing on the balance of purchase price or such*

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part thereof as shall for the time being remain unpaid and secondly in or towards payment of the balance of the purchase price (added by the Board).

- (iv) *Early repayment in whole is allowed provided that not less than one month's written notice of such early repayment shall be given by the purchaser to the vendor and an additional sum equal to 2 month's interest on the balance of purchase price for the time being remaining outstanding or 2% of the balance of purchase price for the time being remaining outstanding whichever is the higher shall be paid by the purchaser to the vendor. Provided that the said additional sum shall not be payable in the event that the purchaser is being called upon by the vendor to complete the sale and purchase of the said premises pursuant to clause 2(a) hereof (added by the Board).*

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- (a) *If, at any time after the execution of this supplemental agreement, the vendor shall have made arrangement for financing by banks and/or financial institutions for the balance of purchase price which shall for the time being remain unpaid by the purchaser on terms and conditions comparable to the terms and conditions set out in clause 1 above, the vendor shall have the right to require the purchaser to complete the purchase within 14 days of the giving of a notice served by the vendor calling upon the purchaser to complete the same. The purchaser shall upon completion accept an assignment of the said premises from the vendor and execute mortgage(s) and/or legal charge(s) (in the form of first mortgage and/or second mortgage) of the said premises in favour of the bank(s) and/or financial institution(s) designated by the vendor to secure payment of the balance of purchase price (added by the Board).*

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...

- 4 *The purchaser hereby agrees and acknowledges that the vendor has fulfilled all the obligations under the said agreement in particular, the proving of the vendor's title and the delivery of vacant possession of the said premises save and except the vendor's obligations to assign the said premises to the purchaser upon compliance of the terms and conditions therein contained (added by the Board).*

...

- 7 *Subject to compliance with the terms and conditions of this supplemental agreement and notwithstanding the fact that the assignment in respect of the said premises has not been executed, the vendor shall permit the purchaser to enter into possession of and occupy the said premises as a licensee of the vendor only (and not as its tenant or the owner thereof) for a period (the licence period) from the date of this supplemental agreement and expiring on the completion date referred to in clause 6 hereof subject to the terms and conditions hereof (added by the Board).*

8

...

- (vii) *The purchaser shall not sub-sell the said premises or assign the benefit of the said agreement and this supplemental agreement to any person except with the prior written consent of the vendor who may, upon giving such written consent, impose such terms and conditions at its absolute discretion ...*

- (10) The assessor was of the view that the Taxpayer's accounting treatment in respect of the profit earned on sale of properties on an instalment basis was correct and that the tax treatment should follow the accounting treatment. He therefore raised on the taxpayer the following 1996/97 additional profits tax assessment:

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| | |
|---|--------------------|
| | \$ |
| Assessable profits per accounts | 524,441,154 |
| <u>Less</u> : Set-off of loss brought forward | <u>635,880</u> |
| Net assessable profits | 523,805,274 |
| <u>Deduct</u> : Amount already assessed | <u>430,081,462</u> |
| Additional assessable profits | <u>93,723,812</u> |
| Additional tax payable thereon | <u>15,464,429</u> |

(11) The Taxpayer objected to the additional assessment in the following terms:

‘ We object to the additional profits tax assessment on the grounds that the assessment on the unearned profit is without any basis and unjustifiable. The adjustment in respect of “unearned profit” attributable to instalments outstanding by purchaser on properties sold is one of the adjustments commonly made to adjust the profit as shown by a company’s profit and loss account into an “adjusted profit” for profits tax purpose. The adjustment is computed on the authority of the case CIR v Montana Lands HKTC 314 and the prevailing practice of the Inland Revenue Department as endorsed by Departmental Interpretation and Practice Note No 1 which recognizes that the purchaser of a flat contracts for a title in the form of a registrable deed of assignment of the property agreed to be bought and sold, and the profits and realised in relation to each instalment received, over a period.’

(12) On 14 September 1998, the CIR determined and confirmed the additional profits tax assessment in (10) above.

(13) By a letter dated 13 October 1998, the Taxpayer’s representative gave notice under section 66(1) of the Inland Revenue Ordinance (the IRO) of appeal against the determination of 14 September 1998.

Grounds of appeal

3. The notice of appeal states that the Taxpayer is appealing on the grounds that the CIR was wrong in determining that the profits in the amount of \$93,723,815 as assessed under additional profits tax assessment for the year of assessment 1996/97 dated 21 October 1997 were derived during the basis period for that year of assessment. Cases cited in support included the Montana Lands case.

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Parties and witnesses

4. At the hearing of this appeal, Mr Robert Kotewall, SC, with Mr Stewart Wong appeared for the Taxpayer, while Ms Gladys Li, SC, with Mr Nelson Miu, appeared for the CIR. Three witnesses were called for the Taxpayer: Mr C, executive director of the parent company of the Taxpayer, Professor D, accountancy expert and Mr E, accountancy expert. One witness, Mr F, accountancy expert, was called for the CIR. No other witness was called.

Testimony of the first witness, Mr C

5. The testimony of the first witness, Mr C, including his witness statement put in by consent as part of his evidence in chief, is briefly as follows:

In chief

- 5.1 He received his secondary school and university education in Country G and holds a B Sc (Engineering) Honours degree and a M Sc degree (now re-titled the MBA degree) from two different universities in Country G.
- 5.2 He has taken a number of courses in the banking and finance areas in Hong Kong and overseas. In 1980, he qualified as an associate member of the Chartered Institute of Bankers (ACIB) in Country G.
- 5.3 For a few years in the eighties, he served as a part-time lecturer in the finance subjects for the MBA program at a university in Hong Kong.
- 5.4 He joined the A Group of Companies in 1987 with primary responsibilities for the overall finance function of the group. In the eleven years before he did so, his working experience covered a wide area in banking, holding increasingly senior positions in an international bank and two local banks.
- 5.5 His employment in the banking industry in Hong Kong mainly involved responsibilities for marketing and credit decision-making functions covering both the local corporate banking and retail banking areas. He was familiar with credit policies generally adopted by banks for housing mortgage loans and he has kept up his knowledge of such policies since joining the A Group. He is also generally familiar with the sales and finance functions and operations of local property developers.
- 5.6 He holds a number of positions in the A Group, including director and general manager (finance) of Company A and chief executive officer of a finance

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company in the A group. He has personal knowledge of the general considerations taken into account by the Group and its member companies, including the Taxpayer, in relation to the adoption and implementation of accounting policies in connection with the recognition of revenues and profits from sale of units in development projects.

- 5.7 The treatment of income from the sale of units in property development projects of the Group and its subsidiaries has always been consistently applied at all times by adopting the ‘full accrual method’ and the same has also been consistently adopted by the Taxpayer. Thus, a subsidiary of the Group that undertakes the development would book the full revenue and recognise the full profits upon the sale of the relevant property unit unless the occupation permit has not been issued, in which case the revenue would only be booked when the occupation permit or the completion certificate was issued, including revenue from units sold under an instalment payment method. The full accrual method was adopted for all sales, whether made under the instalment payment method or otherwise.
- 5.8 At the time of pre-sale, the Taxpayer offered four different payment methods (see paragraph 2(4) above). Although the sales brochure stated that the period of repayment for the immediate instalment payment method (the IIP method) was fifteen years (or a-hundred-and-eighty months), some of the units sold under this method had a twenty-year (or two-hundred-and-forty-months) repayment period.
- 5.9 Pre-sales commenced on 8 December 1994. The occupation permit was issued on 6 February 1996. During the pre-sale period, nine purchasers opted for the IIP method. Eventually a total of twelve units were sold under this method.
- 5.10 The accounting policy relating to recognition of revenue for the A Group’s property development business is set out in the annual reports of Company A. An extract of the annual report for 1997/1998 is as follows:

‘ 1(f) Recognition of revenue

- (i) Revenue arising from the development of properties for sale together with the interest earned on the instalment sales of properties are recognised upon the sale of properties or the issue of an occupation permit or a completion certificate by the relevant government authorities, whichever is the later. Deposits and instalments received on properties sold prior to the date of revenue recognition are included in the balance sheet under

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forward sales deposits received.'

- 5.11 In the financial accounts of the Taxpayer, the revenue and profits from the sale of development units were recognised fully and immediately in the financial year relating to the sale transactions concerned in accordance with the same accounting policy relating to the recognition of revenue as set out in paragraph 5.10 above.
- 5.12 All companies of the Group which offered the immediate instalment method as an option adopted the same accounting policy, that is, using the full accrual method for all sales, as it was considered inappropriate to adopt any other accounting policy because:
- (a) The immediate payment method would always only account for a percentage of total sale which is not high, and its effects would be insignificant in an accounting sense. For the Taxpayer, the proportion was 10% (twelve out of a-hundred-and-twenty units sold) or 11.5% (\$82,256,930/\$714,823,275).
 - (b) Historical housing loan delinquency ratio was well below 1% as evidenced by statistics relating to housing mortgage loan portfolios of leading commercial banks providing housing mortgage loans in Hong Kong. (Delinquency and loss experience records of two leading banks in Hong Kong attached.) For the Taxpayer, purchasers who selected the immediate payment method are generally of a less desirable quality as compared with housing mortgage loans borrowers of the commercial banks and therefore assuming that a higher-than-average delinquency ratio will apply to immediate instalment payment method customers, the effect to the Taxpayer on revenues or profits resulting from any potential delinquency will still be of a magnitude that is unlikely to be material to the company as a whole.
- 5.13 The reasons for the Taxpayer to adopt the full accrual method for all sales, including those under the instalment payment method were:
- (a) It had long been the policy adopted by the A Group to use such a method; and
 - (b) Sales under the instalment payment method constituted only a small and insignificant part of the total sales (in particular if the default rate was applied) and was not considered a sufficient reason to depart from the long established accounting policy which, as a matter of prudence, was

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not to be changed in the absence of a strong reason.

- 5.14 All companies in the Group which sold units under instalment payment method used the full accrual method in the accounts. But when it came to tax computations, they would always take out from the profit a sum being a proportional part thereof referable to unpaid instalments for those units sold under the instalment payment method similar to what the Taxpayer has done here. As far as he is aware, the Revenue has always accepted such tax computations every time up to now. The Taxpayer is the first case where the Revenue has disputed and disallowed the computation.
- 5.15 During the pre-sale period between December 1994 and February 1996, the Taxpayer received and processed nine applications from purchasers who selected the immediate payment method. Three out of the nine purchasers subsequently paid the balance of the purchase price in full before 30 June 1996 and the balance of the purchase price due by the remaining six purchasers as at 30 June 1996 amounted to \$34,950,577.32 and this amount was included in the total instalments receivable as at 30 June 1996 in the amount of \$128,651,613.69. After the occupation permit was issued on 6 February 1996, seven purchasers who originally had not selected the immediate payment method, subsequently, due to failure in obtaining finance for payment of the balance of purchase price, entered into a supplemental agreement with the Taxpayer providing for payment of the balance of purchase price by monthly instalments. One out of the seven purchasers settled the balance of purchase price in full before 30 June 1996, and the total instalments receivable as at 30 June 1996 included \$37,997,558.37 in respect of the balance of purchase price due by the remaining six purchasers. Thus a total of twelve units were involved in the immediate payment method as at 30 June 1996. The total instalments receivable as at that date also included \$55,703,478 due by ten other purchasers in respect of lump sum balance of purchase price. Of the figure of \$57,480,906 listed under Current assets – instalments receivable, only \$1,777,428.60 was referable to the units under the immediate instalment payment method.
- 5.16 The vast majority of purchasers of the Property 1 selected payment methods which involved housing mortgage loan financing by banks for which the cash inflow normally occurred within two months from conclusion of the provisional sale and purchase agreements. Only twelve out of a-hundred-and-twenty units chose the instalment method.
- 5.17 From a financial management perspective, if profits tax for the relevant property units were to be paid immediately under the immediate instalment method, this

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could have involved negative cash outflow for the Taxpayer at a time when about 90% of the relevant sale proceeds still remains unpaid upon booking of a pre-sale transaction and when the tax amount on the profit element exceeds the amount that the Taxpayer would receive from the purchaser by way of downpayment. As at 30 June 1996, the Taxpayer had only received \$9,308,794.31 (\$82,256,930 - \$72,948,135.69) from the twelve units. The total profits referable to those twelve units were:

$$\$517,221,811 \times \frac{82,256,930}{714,823,275} = \$59,518,317$$

If the Taxpayer is required to pay profits tax on the full amount of \$59,518,317 immediately in the year of sale or completion at 16.5%, this would be \$9,820,522.31 which exceeded the actual amount (\$9,300,000) received in respect of the twelve units for the financial year ended 30 June 1996.

- 5.18 The development company would book the full revenue and recognise the full profits upon sale of the relevant property units when the occupation permit or the completion certificate was issued. The full accrual method was adopted for all sales whether the sales were made under the immediate instalment payment method or otherwise. The IIP method would always only account for a percentage of total sales, which is not high.
- 5.19 In tax computations property development companies of the Group would always take out from the profit a sum being a proportional part referable to unpaid instalments, similar to what the Taxpayer has done, and the Revenue has in the past always accepted such tax computations. There have not been any changes in respect of the accounting policies of the Group over the years.
- 5.20 In the financial accounts of the Taxpayer this accounting treatment was followed since the inception of the Taxpayer, and in the opinion of the Taxpayer reflects a true and fair view of the financial position of the Taxpayer.

Cross-examination

- 5.21 A pre-sale is a sale. It refers to those transactions which are signed before the occupation permit of the relevant project is issued.
- 5.22 The options offered to potential purchasers at the time of pre-sale included an option to pay the purchase price by the IIP method.

[Ms Li referred to the sample transaction of a purchaser, and to the extract of a

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page of a price list showing the four options, four payment methods, the provisional agreement for sale and purchase, the formal sale and purchase agreement dated 1 March 1996, the supplemental letter dated 5 March 1996 and the supplemental agreement.]

- 5.23 He agreed that completion of the purchase should take place when the balance of purchase price should be paid and the vendor would then assign on that date the property to the purchaser.
- 5.24 The purchaser is entitled to sub-sell at any time before completion.
- 5.25 The understanding was that the balance of purchase price was to be paid on or before 26 March 1996 and that would be the date of completion. The balance of the purchase price to be paid on 26 March 1996 was \$6,480,000. The purchaser, having failed on that date to come up with the balance of the purchase price, the vendor had the option of exercising the rights to forfeit the deposit and any instalments paid and to exercise the rights of resale. Instead the vendor accepts the purchaser's request and enters into the supplemental agreement (see paragraph 2(9)(d) above). This is typical of the other units to which the instalment method has been applied.
- 5.26 He agreed that the supplemental agreement contained, inter alia, the provisions shown in paragraph 2(9)(d) above, and, in particular, those relating to the purchaser's right to early completion upon early repayment of the balance of purchase price in whole, and the vendor's right to early completion upon the making of arrangements for financing by banks and/or financial institutions the unpaid balance of purchase price.
- 5.27 For the kind of financing they would provide, they would normally charge higher interest rates than a bank. Now, they were also offering a first legal mortgage. They were also offering other forms of financing. All of these would typically be higher than what the banks would charge.
- 5.28 As a general statement, people must be making efforts to try to pay a lower interest rate. Whether they can do that depends on many things. Among others there would be income proof, occupation, age, age of the building. He cannot anticipate as to whether they would be able to find refinancing so easily. They have to pay prepayment penalty. He had mentioned the two months' interest that would be charged. Other negative factors are legal fees for the assignment, funding fee in certain cases for going to the bank that would provide the financing.

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- 5.29 As for the vendor finding alternative financing for the purchaser, although there are provisions in the agreement, it is not the intention of the Taxpayer to sell or transfer financing. They had not done so in the past.
- 5.30 In the case of other companies in the A Group, there are instances where the purchaser had completed before the fifteen or twenty-year period has elapsed.
- 5.31 As for the Taxpayer, eleven out of the twelve units completed the purchase within eighteen months or so. That is in a way quite an unusual, and quite a high rate of early prepayment. It may again depend on a number of factors, such as maybe 1996 was a year when people purchased properties and then prices appreciated. Maybe they disposed of the units for profit.
- 5.32 In his experience the Hong Kong Monetary Authority would have very clear guidelines to disallow or to persuade commercial banks not to take non-self-residing units for mortgage purposes. They should do mortgage financing for the end-users.
- 5.33 He would not exclude the possibility that in a rising market somebody who has purchased as a trading activity, will complete the purchase in order to realise a profit.
- 5.34 His experience is more limited to financing purchasers whereas in his previous experience in banks it was more to do with financing end-users. When it comes to traders he has to make a guess. That is not his expertise.
- 5.35 [Referring to clause 4 of the supplemental agreement (see paragraph 2(9)(d) above),] it is correct that the vendor has by the date of the supplemental agreement proved that the vendor has good title to transfer to the purchaser. The vendor has not assigned the premises. That remains to be done.
- 5.36 [He was referred to clause 8(vii) of the supplemental agreement set out in paragraph 2(9)(d) above.] That is correct.
- 5.37 The purchaser has four options to choose from for paying the purchase price. If he opts for the IIP method, the application still has to be approved by the company, who will assess the purchaser according to criteria. If not satisfied, the company will not approve the application.
- 5.38 [Referring to accounting policy regarding the recognition of revenue (see paragraph 5(10) above),] a unit is pre-sold, and then it comes to the financial year in which the property is completed, and they will recognise revenue and

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profit in that year. So, if the property is sold before the issue of the occupation permit, then revenue will be recognised upon the issue of the occupation permit. If the property is sold after the issue of the occupation permit, then revenue will be recognised on the sale of the property, which should mean ‘ on the execution of the formal sale and purchase agreement’ . The words ‘ together with the interest earned on the instalment sales of properties’ refer to all sales, and not just those under the instalment payment method.

- 5.39 [Being referred to a table, an appendix to his statement, and to the second column for the date of provisional sale and purchase agreement,] the date of recognition of revenue is not evidenced from this table, which is prepared under his direction for the purpose of showing the analysis of the instalments receivable, and is not meant to give an indication of when the profit would be booked.
- 5.40 Profit should be booked, he believes, when the formal sale and purchase agreement is signed. He would like to obtain legal advice as to whether a sale is confirmed or regarded as confirmed in the legal sense when the provisional sale and purchase agreement is signed or when a formal agreement is signed. He does not know at this point, but he could give the answer with the time allowed to research into it.
- 5.41 They have records of sales with a reference to an option of the IIP method and such records can be traced back to 1994. He believes that the A Group started to offer this option in the later part of the 1980’ s.
- 5.42 In the year ended 30 June 1996, a-hundred-and-eight units were sold out of a hundred and twenty. Some units were sold with car parking spaces, while others were not.
- 5.43 [Being shown the Taxpayer’ s accounts for the year ended 30 June 1996,] he is not a director of the Taxpayer. Two directors of the Taxpayer signed the accounts.
- 5.44 Mr Kotewall accepts Ms Li’ s suggestion that completion took place in relation to six of the units in the year ended 30 June 1997 and in relation to five of them in the year ended 30 June 1998.

In re-examination

- 5.45 When he joined the A Group in 1987, the IIP method was already in operation.
- 5.46 There is no pre-set payment method preferred by them. They would provide

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different payment methods to attract purchasers and to facilitate their purchase of the flats but in the process they would try to compensate themselves. Factor no 1 is that they provide finance of a higher percentage than what the commercial banks will offer. They provide up to 90% while the banks offer a maximum of 70%.

- 5.47 Factor no 2 is the debt service ratio (DSR), the monthly repayment obligations of a purchaser as a percentage of his monthly income, such rate not to exceed 60% of the total instalment payments. Various banks have different policies, but on the whole they adopt the debt service ratio of 40 to 50%. 40% for people earning less than \$30,000 per month. For those earning \$30,000 or more it could be 50%. But 60% would be on the high side.
- 5.48 In his experience as a former banker and having been with the A Group for the past twelve, thirteen years, he would say that those who would choose the IIP method would be purchasers who had some difficulty in obtaining finance or mortgage finance from the commercial banks. Another situation is related to the equity or money available to a purchaser for making down payment deposit. For example, if he is purchasing a unit and he only has 10% of equity, it would not be possible for him to seek 90% financing from the bank so he would have little choice but to look to financiers who would provide more than 70%. Under the IIP method, they would offer up to 90% financing, so if he has less than 30% equity, the IIP method would be the thing he would be looking at.
- 5.49 Another aspect is that he may have no proof or no formal proof of income. The commercial banks would like to see written evidence of regular income. On the other hand, they would accept declaration by the intending purchaser.
- 5.50 In relation to the twelve units in question, they have done some statistics and have found out that seven out of the twelve purchasers who elected the IIP method had their debt service ratio exceeding 50%. Add two more who exceeded 40% and there would be seven out of twelve purchasers that exceeded 50% and nine out of twelve exceeding 40%. You would say that seven or nine purchasers would not be qualified to apply for a mortgage loan from a commercial bank.

Testimony of the second witness, Professor D

6. The testimony of the second witness, Professor D, including his witness statement put in by consent as part of his evidence in chief, is briefly as follows:

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In chief

- 6.1 He began his career in 1977 with an accounting firm in Hong Kong. In 1980, he joined a finance company as manager in charge of the audit division and the insolvency division. During 1984 to 1985, he briefly joined another finance company as manager with the financial and accounting division.

In 1985, he established his own practice and his firm later merged with Company H in 1990. Besides serving as an audit partner, he was also responsible for the Country I operation of Company G International as well as the management consulting division of the Hong Kong firm. He joined a university in Hong Kong as adjunct professor with the Department of Accountancy, Faculty of business, and re-established his own practice in 1998.

- 6.2 He holds a Doctor of Philosophy degree in Accountancy and a Master of Business Administration with a university in Hong Kong. He also holds professional qualifications with HKSA, the Taxation Institute of Hong Kong and the Chartered Association of Certified Accountants in Country H. He is also a member of the institute of Certified Public Accountants in Country I. He is also a member of some of the boards, committees and sub-committees with the HKSA.

- 6.3 [Referring to the Taxpayer's accounting policy in relation to the recognition of revenue, including sales under the IIP method, as disclosed in the audited financial statements of the Taxpayer as of 30 June 1996 (see paragraph 2(6) above),] under this accounting policy, revenue and profit from the sale of properties were recognised upon the issue of an occupation permit or upon sale of properties, whichever is the later. No deferment of revenue or profit has been made for those sales concluded by way of the IIP method. This will be referred to as the full accrual method.

- 6.4 In its appeal against the CIR's determination relating to the additional profits tax assessment for the year of assessment 1996/97, the Taxpayer submitted that the instalment method of recognising revenue and profit would equally be the appropriate method for adoption. Under the instalment method, revenue is recognised on cash payments made to the Taxpayer by the purchaser using the IIP method, while profit is accounted for on the basis of cash received with reference to the percentage of gross profit to total sales value.

- 6.5 He has been asked to express his view as to (1) whether the facts and circumstances of the Taxpayer would render the full accrual method the only appropriate method for the Taxpayer for the year ended 30 June 1996 and (2)

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whether the instalment method could also have been appropriate for the Taxpayer for the recognition of revenue from the sale of properties under the IIP method for that year.

6.6 Based on the facts and circumstances of the Taxpayer, there are factors in favour of the adoption of either the full accrual method or the instalment method.

6.7 Factors in favour of the full accrual method include:

- (1) The full accrual method is the prevalent market practice adopted by similar firms in the same industry;
- (2) The full accrual method has been followed since the inception of the Taxpayer and is consistent with the accounting policy that is adopted by the Taxpayer's parent and its fellow subsidiaries. A separate accounting policy to cater only for such a small percentage of transactions did not appear to be warranted; and
- (3) There is no evidence (up to 11 September 1996 when the audited financial statements were approved) that the buyers at large under the IIP method would withdraw from their commitment by defaulting their payments.

6.8 On the other hand, there are factors in favour of the instalment method. They relate to the adverse indicators of individual buyers' commitment to pay for the properties:

- (1) Buyers under the IIP method are typically of the less affluent sector. There may be doubts on the ability of these buyers to fulfil their continuing obligations;
- (2) High debt servicing ratios of the buyers coupled with high loan-to-value ratios might also dent the required evidence of the buyers' ability to complete payment;
- (3) Instalments of only 11.32% of total sales value received up to 30 June 1996 were low as compared with the 19.5% required under the US standard (no equivalent guidelines in Hong Kong) for sales to be accounted for by the full accrual method; and
- (4) The length of exposure period to complete the transaction adds to the uncertainty with respect to the buyers' commitment to fulfil their

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continuing obligations.

These factors, however, are mitigated by the low delinquency rates experienced by various financial institutions for local residential mortgage loans. In other words, with the historically low percentage of buyers of residential properties defaulting payments, the probability of any negative implication on the outstanding receivables would be insignificant.

- 6.9 It follows that there is a range of factors to consider in deciding which accounting policy on revenue recognition - the full accrual method or the instalment method - should be adopted by the Taxpayer so that the financial statements would reflect a true and fair view of the Taxpayer's financial position.
- 6.10 It seems that management of the Taxpayer has exercised an informed judgment in deciding that the full accrual method is appropriate in the circumstances, and the adoption of such accounting policy would constitute a true and fair view for the financial statements of the Taxpayer.
- 6.11 Some factors may not be relevant. Particular reference is made to the witness statement of Mr F.
 - (1) The opinion expressed by the Taxpayer's auditors. The auditors stated in their reports that 'it [an audit] also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the accounts, and of whether the accounting policies are appropriate to the Taxpayer's circumstances, consistently applied and adequately disclosed.' Studies have shown that auditors tend to rely to a greater extent on precedents that are similar to the problem situation. In the presence of conflicting arguments, the auditors would likely follow the prevailing practice. Hence, having given due regard to the auditor's judgment process, the auditor's opinion shall not be taken as overwhelming in the assessment of whether the full accrual method is the only appropriate accounting policy. It is clear that the evidence on hand is mixed and that cogent factors justifying the adoption of the instalment method exist.
 - (2) Events subsequent to 11 September 1996 should not be taken into consideration. As far as the Taxpayer's management and auditors are concerned, they were making a judgment on the appropriateness of the accounting policy choice for the financial statements as of 30 June 1996, based on facts and evidence available to them up to 11 September 1996.

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Events that took place thereafter could not have been considered at that point in time and are therefore irrelevant.

- (3) Dividend payments for the year ended 30 June 1996 were made given the circumstances and within the context that the full accrual method had been regarded as appropriate.
- 6.12 Some accounting numbers in Mr F's statement are factually incorrect. The \$57,500,000 current instalments receivable as shown in the audited financial statements of 30 June 1996 in fact includes outstanding payments of \$55,703,478 that relates solely to sales other than those under the instalment sales method. Outstanding instalments that relate to sales under the instalment sales method amounted only to \$1,443,757, plus another \$333,672 which was overdue.
- 6.13 Based on the Statement of Standard Accounting Practice No 18 issued by the Hong Kong Society of Accountants, there are two common methods of recognising revenue for the sale of properties under the IIP method. They are the full accrual method and the instalment method. A relevant factor distinguishing the adoption of these two methods is whether there is evidence on the buyer's commitment to complete payment with reference to the buyer's initial and continuing payments.
- 6.14 In evaluating which accounting method is more appropriate, it is important to assess the 'spirit and reasoning' behind the decision. Based on the information provided, management of the Taxpayer has exercised their informed judgment by evaluating the relevant factors. It is his opinion that, for the purposes of preparing the financial statements for the year ended 30 June 1996, although the full accrual method is appropriate in the circumstances, there are certainly factors which support the adoption of the instalment method. It would have been entirely appropriate and prudent to warrant the instalment method to be at least as appropriate given those factors.

In cross-examination

[Mr Kotewall stated that one unit out of the twelve was completed in August 1996 so that there was no completion before 30 June 1996 but there was one before 11 September 1996.]

- 6.15 He was not given the actual dates of completion.
- 6.16 By the full accrual method all the revenue would have been recognised upon the

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sale of the properties, upon the execution of the sales agreement in accordance with the accounting policy, even if the instalments cover a period of fifteen to twenty years.

- 6.17 A cash basis would not recognise profit until the cash is received.
- 6.18 Given that the buyers have already committed or there are indications that the buyers will be able to repay everything so that the title will be passed to the buyer, then, of course, the full accrual method will be appropriate.
- 6.19 It is correct that, in order to decide on the appropriateness of the full accrual method for a company that does not employ the IIP method, the company still has to assess the appropriateness of using the full accrual method by trying to assess the commitment of a purchaser to complete. So the assessment exercise which is a matter of judgment for the company with its experience in the development field, is the best indicator of whether it is the appropriate method to use.
- 6.20 He has studied the relevant issues surrounding the Taxpayer as to which accounting policy would have been appropriate at 30 June 1996, in the recognition of revenue from the sales of the properties under the IIP method. In the process of doing that he would also study the view of the Taxpayer's management in the adoption of the relevant policies which could be derived from the Taxpayer's accounts. He has also looked into the Taxpayer's financial management and credit policies which is stated in Mr C's statement. He agrees with Ms Li that that is the document which refers to prepayment not being permitted.
- 6.21 The major sources of information are the accounts as well as the Taxpayer's management's view as to which accounting policy is appropriate. He would also look at the volume of sales under the IIP method, the environmental situation.
- 6.22 It is correct that purchasers may be more committed to completing a purchase in a environment where the market is rising.
- 6.23 If the deposit represents a substantial proportion of the purchaser's savings, then it is probably right that, from the purchaser's point of view, the purchaser is more likely to want to complete if he possibly can.
- 6.24 Given the market being so fluctuating in Hong Kong, formulating an accounting policy should be for the long term, and it is not common for companies to be

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changing accounting policies to reflect the market situation. He would suggest that the market situation would be one of the factors that the board of directors or management would take into consideration.

- 6.25 He agreed that most trading businesses would follow the accruals concept, rather than the cash concept and that the cash basis is the exception rather than the rule.
- 6.26 [Ms Li referred to ‘ factors in favour of the full accrual method’ , to the last point that there is no evidence that the buyers at large would withdraw from their commitment by defaulting payments and to the fact that one of the buyers completed by 11 September 1996.] That only adds to the factors indicating the appropriateness of the full accrual period under the circumstances.
- 6.27 The expression ‘ the instalment method’ is not from the standards or guidelines of the Hong Kong Society of Accountants. It is a reference to the US standard.
- 6.28 As for the factor in favour of the instalment method, buyers under the IIP method are typically of the less affluent sector, that is based on two things. One was the statement of Mr C. The second thing is the supplemental agreement where it was mentioned that the buyer typically could not secure mortgage loans from banks obviously for financial reasons.
- 6.29 It is entirely possible that wealthy speculators may prefer not to go through the paperwork of getting a mortgage.
- 6.30 High loan-to-value ratio is an indicator that the buyer might be unable to complete payment.
- 6.31 It is probably right that, given a rising market, and given the effect that is going to have on the loan-to-value ratio, the buyer might well be able to transfer to bank financing. But in their experience, the property market in the last fifteen years has been fluctuating. And also they are looking at the situation as of 30 June 1996, or 11 September 1996. There is no guarantee that the market will [not] be coming down again given the fluctuating characteristic of the market. Of course it is a factor that the directors of a property development company are particularly well placed to judge.
- 6.32 Prior academic studies show that auditors tend to rely on precedents as persuasive evidence in judging whether an accounting policy is appropriate in the circumstances. So, if there is a difference between a precedent and a position that a company follows in adopting a certain accounting policy, the

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auditor would tend to rely on the precedent and do not heed the client's position. Here he refers to his statement that 'therefore in the presence of conflicting arguments, the auditors would likely follow the prevailing practice.'

- 6.33 [He was referred to the following paragraphs in the auditors' report to the shareholders of the Taxpayer dated 11 September 1996:

Respective responsibilities of directors and auditors

The Companies Ordinance requires the directors to prepare accounts which give a true and fair view. In preparing accounts which give a true and fair view, it is fundamental that appropriate accounting policies are selected and applied consistently, that judgments and estimates are made which are prudent and reasonable and that the reasons for any significant departure from applicable accounting standards are stated.

It is our responsibility to form an independent opinion, based on our audit, on those accounts and to report our opinion to you.

Basis of opinion

We conducted our audit in accordance with Statements of Auditing Standards issued by the Hong Kong Society of Accountants. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the accounts, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.]

The significant estimates and judgments made by the directors included the appropriateness of paying an interim dividend based on profit of approximately \$524,000,000. The auditors are considering whether the estimates and judgments made by the directors are appropriate.

- 6.34 Where there are no authoritative guidelines in Hong Kong, previous studies have shown that the auditors would likely look elsewhere, including precedents from various sources, to make their judgment as to whether estimates for the judgment made by the directors are appropriate in the circumstances.
- 6.35 It is true that there is no evidence that the directors or the auditors thought that the instalment method was appropriate in the circumstances of this company at

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this particular date, but the point is that, given the circumstances, given these factors, if he was asked to form an opinion as to whether the instalment method could have been appropriate in the circumstances, his answer would be yes.

- 6.36 He agreed that he was not necessarily privy to all the information which the directors and auditors had in coming to their view that the full accruals method was the appropriate method to use.

Re-examination

- 6.37 The term ‘instalment method’ is not found in the Hong Kong Society of Accountants Standards. To the best of his belief, the concept underlying the term is familiar to accountants practising in Hong Kong. In fact, the concept is exactly what is mentioned in Statement 2.118 promulgated by the Hong Kong Society of Accountants, although they did not use the term ‘instalment method’.

Testimony of the third witness, Mr E

7. The testimony of the third witness, Mr E, including his witness statement put in by consent as part of his evidence in chief, is briefly as follows:

In chief

- 7.1 Following his graduation from a university in Country J in December 1980, he commenced his career with an accounting firm in Hong Kong in March 1981. In June 1984 he was admitted as a chartered accountant in Country J. He transferred to the office of this accounting firm in Country J in October 1984 and returned to the Hong Kong office in October 1988. He was admitted to the partnership of this accounting firm in Hong Kong in July 1992.

He has audited many property development companies.

He is a Fellow member of the Hong Kong Society of Accountants (HKSA) and a certified public accountant in Hong Kong. He has also served on the Council of HKSA.

- 7.2 Statements of Standard Accounting Practice 2.118 ‘Revenue’ applies to accounting for revenue arising from inter alia the sale of goods where goods includes ‘land and other property held for resale.’ Clause 13 states that revenue from the sale of goods should be recognised when all the following conditions have been satisfied:

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- (a) the enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods;
- (b) the enterprise retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- (c) the amount of revenue can be measured reliably;
- (d) it is probable that the economic benefits associated with the transaction will flow to the enterprise; and
- (e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

7.3 The appendix to Statement of Standard Accounting Practice 2.118 states on property sales:

‘ Revenue is normally recognised when legal title passes to the buyer. However, the equitable interest in a property may vest in the buyer before legal title passes and therefore the risks and rewards of ownership have been transferred at that stage. In such cases, provided that the seller has no further substantial acts to complete under the contract, it may be appropriate to recognise revenue.’

‘ A seller must also consider the means of payment and evidence of the buyer’s commitment to complete payment. For example, when the aggregate of the payments received, including the buyer’s initial down payment, or continuing payments by the buyer, provides insufficient evidence of the buyer’s commitment to complete payment, revenue is recognised only to the extent cash is received.’

7.4 His understanding of the supplemental agreement relating to one of the twelve units sold under the IIP method is that the buyer assumes the risks and rewards of ownership and that there is no substantial or continuing involvement on the part of the Taxpayer. Assuming that significant risks and rewards have been transferred to the buyer there are two acceptable methods of accounting for the sales:

- (a) Instalment method – sales recognised only to the extent of cash received.

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(b) Full accrual method – sales recognised in full.

The choice of method depends on the economic substance which the directors want to reflect in the financial statements.

- 7.5 The full accrual method is the method which management adopted to account for sales including those under the IIP method in the preparation of the financial statements for the year ended 30 June 1996.
- 7.6 The ratio of current instalment receivables to total instalment receivables at 30 June 1996 should be 2.4% ($\$1,770,000/\$72,800,000$) and not 45% ($\$57,500,000/\$128,700,000$) as calculated by Mr F. The amount of $\$55,703,478$ being outstanding payments for units sold otherwise than under the IIP method, should be excluded from current instalment receivables. Further, the $\$57,500,000$ included $\$333,672$ being instalments due under the IIP sales before 30 June 1996, but not paid as at that date. Adopting a pure receipt basis, as apparently Mr F did, and so treating the amount of $\$333,672$ as part of the current instalment receivables, the ratio is 2.4%.
- 7.7 He understood from the statement of Mr C that, in preparing the financial statements for the year ended 30 June 1996, the directors had taken into consideration the materiality of the financial effect of the sales under the IIP method in relation to the total sales for that year, with the objective of presenting fairly the results of the overall performance of the Taxpayer as a developer.
- 7.8 Despite the choice of full accrual method to account for the sales including those under the IIP method, the directors had elected to adopt the instalment method for the purpose of preparing the profits tax return to account for those sales in respect of which repayments had not been received at the balance sheet date.
- 7.9 In his report, Mr F stated that the declaration and payment of interim dividends of $\$430,000,000$ in support that management were satisfied with the purchasers' commitment to complete payment. He disagreed with that conclusion. Dividends were paid to the parent company. This was simply a mechanism for moving assets to the parent company. He did not consider that the payment of dividends is necessarily an indicator of expectations as to whether amounts were collectible. Rather having elected to use the full accrual method this amount was treated as dividend.
- 7.10 The amount of instalment receivables at the balance sheet date can be differentiated into outstanding down payments, late instalment payments and instalment receivables attributable to IIP sales. The outstanding down payments

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are not related to the sales under the IIP method and should be excluded from the calculation of the profit to be deferred. The correct formula to be used to calculate the profit to be deferred as the Taxpayer claims is as follows:

$$\text{Profit on property trading} \times \frac{\text{Instalments receivable under the IIP sales}}{\text{Proceeds from sale of flats}}$$

- 7.11 The choice of accounting treatment method depends on directors' decision to reflect which economic substance in the financial statements – performance of a property developer's act or the underlying credit risk of the sale.
- 7.12 In the Taxpayer's circumstances, both the full accrual method and the instalment method are acceptable to be adopted to account for the sale under the IIP method. In making their choice, the directors would have to decide which economic substance they would want to reflect in the financial statements (see paragraph 7.11 above). The factors that the directors would have considered in their decision process are:
- (a) consistency with group accounting policy;
 - (b) consistency in the application of the accounting policy chosen;
 - (c) evaluation of the underlying credit risk; and
 - (d) materiality.
- 7.13 In the Taxpayer's circumstances, he does not observe the presence of any single factor or factors which would have dictated the choice of either the full accrual method or the instalment method to account for the sales under the IIP method. The full accrual method is consistent with the provisions of Statement of Standard Accounting Practice 2.118, although it would have been also appropriate if the management, having regard to the factors, had given more weight to the economic substance of the IIP sales and adopted the instalment method.
- 7.14 At the time of recognising the revenue, the company had done all the things required of it apart from executing the assignment.
- 7.15 At the point when all the five criteria in clause 13 (see paragraph 7.2 above) are satisfied, the revenue should be recognised. This is standard accounting practice.

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- 7.16 In the case of instalment sales it is proper to recognise the revenue at the date of sale exclusive of interest. The interest element is simply recognised as revenue as it is earned.
- 7.17 If the seller is obliged to perform any significant acts after the transfer of the equitable and/or legal title, revenue is recognised as the acts are performed. An example is a building or other facility on which construction has not been completed. That is not applicable in the case of the twelve units.

Re-examination

- 7.18 In considering whether the instalment method is an appropriate method of accountancy treatment, all other things being equal, the length of the repayment period would be a relatively important consideration. Hindsight is one matter but at the time of having to make the decision obviously the length of the repayment period would be one of the important circumstances.

Testimony of the fourth witness, Mr F

8. The testimony of the fourth witness, Mr F, including his witness statement put in by consent as part of his evidence in chief, is summarised as follows:

In chief

- 8.1 He was the faculty of management gold medalist at a university in Country K, upon his graduation in 1977. Thereupon he joined an accounting firm in Country K. He became a chartered accountant of Country K in 1980. From 1988 to 1994, he was the managing partner of the accounting firm's office in Country K and partner responsible for coordinating services and business development activities in Country I for Country K's practice of the accounting firm. In 1994, he transferred to the Hong Kong office and is currently the managing partner, audit and business advisory service, for Country I of this accounting firm.

He presently serves as engagement partner for public companies listed on Hong Kong exchanges and the exchanges of a city in Country I. He actively participates in the various committees of the Hong Kong Society of Accountants (HKSA). Presently he is a member of the HKSA Council and also serves on the a committee of the Hong Kong Stock Exchange.

- 8.2 Accounting Standards are developed and issued in the public interest by the HKSA as being authoritative statements on accounting practice. (HKSA

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Statement 2.0).

- 8.3 Accounting Standards are not intended to be a comprehensive code of rigid rules. They do not supersede the exercise of an informed judgment in determining what constitutes a true and fair view in each circumstance (HKSA Statement 2.0).
- 8.4 In applying Accounting Standards it is important to be guided by the spirit and reasoning behind them (HKSA Statement 2.0).
- 8.5 Fundamental accounting concepts are the broad basic assumptions which underlie the periodic financial statements of business enterprises (HKSA Statement 2.101).
- ... the accruals concept: revenue and costs are accrued (that is recognised as they are earned or incurred, not as money is received or paid), ... provided that where the accruals concept is inconsistent with the prudence concept, the latter prevails ... (HKSA Statement 2.101).
- ... the concept of prudence; revenue and profits are not anticipated, but are recognised by inclusion in the profit and loss account only when realised in the form either of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty ... (HKSA Statement 2.101).
- 8.6 Accounting bases are the methods developed for applying fundamental accounting concepts to financial transactions and items, for the purposes of financial accounts ... (HKSA Statement 2.101).
- 8.7 Accounting policies are the specific accounting bases selected and consistently followed by a business enterprise as being, in the opinion of the management, appropriate to its circumstances and best suited to present fairly its results and financial position (HKSA Statement 2.101).
- 8.8 In his opinion, revenue from the sale of completed properties (after construction work has finished) falls under the scope of HKSA Statement 2.118 (see below).
- 8.9 Regarding the sale of completed properties, the HKSA Statement 2.118 requires revenue from such sale be recognised when all of the following conditions have been satisfied: (a) the seller has transferred significant risks and rewards to the buyer, (b) the seller neither retains managerial involvement

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normally associated with ownership nor effective control, (c) the amount of revenue can be measured reliably, (d) probably economic benefit will flow to the seller, and (e) cost can be measured reliably.

- 8.10 Under generally accepted accounting principles, the commercial substance of a transaction needs to be considered to determine whether risks have been transferred. It is possible for a seller to transfer significant risks and rewards relating to an asset to a purchaser before the transfer of the asset's legal title. In such circumstances, if the seller only retains an insignificant risk of ownership, the transaction is a sale and revenue is recognised. In his opinion, revenue may be recognised before the transfer of the legal title.
- 8.11 In his opinion, revenue from the pre-sale of properties during the construction period may fall under either HKSA Statement 2.103 or HKSA Statement 2.118 (see below), depending on the view taken as to whether the property under construction constitutes a long-term work in progress.
- 8.12 If the property under construction is considered not to be a long-term work in progress, it needs to be accounted for under HKSA Statement 2.118. Revenue from the pre-sale should therefore be recognised when all five specified conditions have been satisfied.
- 8.13 In a pre-sale, a property development needs to complete the construction work and therefore still has substantial ongoing involvement in the property. Typically, enterprises which follow the approach of the HKSA Statement 2.118 adopt an accounting policy of recognising revenue from the sale of properties upon the issue of an occupation permit or upon the sale of properties, whichever is later.
- 8.14 If, on the other hand, the property under construction is considered to be a long-term work in progress, it needs to be accounted for using HKSA Statement 2.103. Profit and revenue from the pre-sale should be recognised to reflect the part of the profit attributable to that part of the work performed before the completion of the construction. Typically, enterprises which follow the approach of the HKSA Statement 2.103 adopt an accounting policy of recognising revenue over the entire period of construction.
- 8.15 Based on his knowledge of local practices and a survey of the accounting policies adopted by some property development companies, both of the above approaches are considered acceptable and have been adopted in practice. There is, so far, no consensus on which of the two accounting treatments is superior. In his opinion, both accounting treatments are equally acceptable and appropriate.

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- 8.16 Under the HKSA Statement 2.118, a reporting enterprise should take into account the means of payment and evidence of the buyer's commitment to complete payment to assess the probability of the flow of economic benefit from the sale transaction. Hence, when there is insufficient evidence of the buyer's commitment to complete payment, revenue is only recognised to the extent when cash is received.
- 8.17 As a general principle, under the HKSA Statement 2.101, a reporting enterprise should apply the prudence concept and recognise revenue and profits not when anticipated, but only when realised in the form of either cash or other assets, the ultimate realisation of which can be assessed with certainty.
- 8.18 Based on the above, if the reporting enterprise considers that the flow and realisation of economic benefit may not be probable until the consideration is received, revenue and profit recognition need to be deferred until the actual receipt of consideration. In his opinion, in such circumstances, it may be appropriate to adopt an accounting policy of recognising revenue upon the issue of an occupation permit or upon the sale of properties, whichever is later, to the extent of consideration received.
- 8.19 However, he must emphasise that whether revenue recognition needs to be deferred or not depends on the enterprise's circumstances, and management is in the best position to make judgement on this.
- 8.20 According to the audited financial statements of the Taxpayer for the year ended 30 June 1996, revenue and profit from the sale of properties were recognised upon the issue of an occupation permit or upon the sale of properties, whichever is the later. No deferral of revenue or profit has been made regarding those sales where consideration has not yet been received in full. The same accounting policy has been adopted by the Taxpayer in its audited statements for the year ended 30 June 1997.
- 8.21 The Taxpayer's auditors had issued unqualified audit reports on the above financial statements. In their reports, the auditors stated that the audit also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the accounts and of whether the accounting policies are appropriate to the Taxpayer's circumstances, consistently applied and adequately disclosed.
- 8.22 The audited financial statements showed that at 30 June 1996 the Taxpayer had total instalments receivable of \$128,700,000, comprising amounts falling due

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within one year of \$57,500,000 and amounts due after one year of \$71,200,000.

- 8.23 When considering the probable flow and realisation of economic benefits, he noted that the ratio of current instalments receivable to total instalments receivable at 30 June 1996 as shown in the audited financial statements was approximately 45% (\$57,500,000/\$128,700,000), even though the maximum payment term was one-hundred-and-eighty months (or two-hundred-and-forty months in one particular case). This indicated that the average payment term was significantly shorter than the maximum term as suggested in the IIP method during the pre-sale. In his opinion, this together with the fact that purchasers paying by instalments on average have already paid approximately 12.5% of the consideration by 30 June 1996, demonstrate the purchasers' commitment to complete the payment. This ties in with the presumption that management is confident in the probable flow and realisation of economic benefit.
- 8.24 The above deduction is further reinforced by the figures shown in the analysis of instalments receivable, which indicated that \$104,700,000 (more than 81%) of the total instalments receivable outstanding at 30 June 1996 were in fact settled within twelve months.
- 8.25 The above view on the probable flow and realisation of the instalments receivable is also consistent with the Taxpayer's dividend payment. It declared and paid an interim dividend of \$430,000,000 during the year ended 30 June 1996, leaving a balance of \$7,400,000 as retained profits carried forward at 30 June 1996. As the dividend payment represented more than 98% of the Taxpayer's profit for the year less accumulated losses brought forward, this indicated that management was satisfied with the purchasers' commitment to complete the payment and regarded the profit relating to the outstanding consideration as realised at the time.
- 8.26 Based on the information provided, he considers that it is appropriate for the Taxpayer to adopt an accounting policy of recognising revenue upon the issue of an occupation permit or upon the sale of properties, whichever is the later, without deferring part of the revenue in relation to outstanding consideration.
- 8.27 There are two common approaches, based on the HKSA Statement 2.118 and 2.103, in relation to the recognition of revenue on the sale of properties and the Taxpayer's accounting policy on revenue recognition is in line with the approach of the HKSA Statement 2.118.
- 8.28 In his opinion, based on the information provided, an accounting policy of not

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deferring part of the revenue in relation to outstanding consideration is more appropriate for the Taxpayer. He concurs with the judgments of the Taxpayer's management of not deferring the revenue recognition in the financial statements for the year ended 30 June 1996.

- 8.29 [To Ms Li] The information available to him when he made his statement towards the end of January this year did not include any breakdown between receivables arising out of the IIP sales and other sales, and that is how he came to the figure of 45% (see paragraph 8.23 above). It affects the considerations that were taken into account in coming to the conclusion because several factors were considered in total in arriving at the conclusion, but on balance it would not change the overall conclusion.
- 8.30 In arriving at the conclusion as to the more appropriate method for revenue recognition in the financial statements of the Taxpayer for 30 June 1996, a number of key factors were considered. They would include: (1) management's assessment; (2) the amounts of down payments received relative to the instalment sales; (3) market conditions at the time; and (4) company and general experience in the industry in terms of delinquencies relating to this type of sales during that period of time. Reference was also made to subsequent payments received by the Taxpayer pertaining to those sales, of which between the period from 30 June 1996 to 1997, the revised figure was 65% during the subsequent year. In consideration of all of those factors above, his overall conclusion is that he would concur with the management's assessment and their choice of accounting method as being the more appropriate one under the circumstances.
- 8.31 The primary responsibility in terms of selecting the appropriate accounting treatment lies with management. The role of auditors really is to assess management's accounting policies and to assess whether or not they were considered as being acceptable in order to reflect a true and fair view for the overall financial statements.

In cross-examination

- 8.32 It is correct that in sales by instalment payment, it is perfectly acceptable and it is not uncommon for both methods to be used in the right type of case.
- 8.33 The 45% only tells about amounts to be due in one year versus more than one year. That amount has changed. Yes, significantly. But, given the market conditions which were very strong at that time, and given prices were going up and given the number of options whereby either the purchaser or the vendor can

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cause payment to be made at an earlier point in time, that factor is less important in terms of assessing the risk of realisation than it would appear on the surface.

- 8.34 When asked why he had not taken into account the fact that the market actually dropped after some time in mid-1996, he stated that accounting treatment and auditing standards would require that even from a management standpoint one would consider all the facts up to the point that the financial statements are finalised, which normally is the date when the directors approve the financial statements. In this case, hindsight did not extend beyond September, but it did extend beyond 30 June.
- 8.35 Hindsight is relevant in terms of his understanding what management were thinking at the time.
- 8.36 In this case management has selected a method and obviously management has tremendous experience about the market and its industry, so management has a view of what the market was like and inherent risk associated with the uncollected part of those sales. So, in looking at the information subsequent to that, even though it is going beyond a number of months, it does help to bear out that management knew what they were doing and made a choice. With the hindsight information it does help me to understand what management did.
- 8.37 He would accept that the property market is capable of severe fluctuation.
- 8.38 At the time when management finalised the financial statements, that would be round September, October 1996, management, based on the information at that time in their assessment of the market in the foreseeable future, were obviously positive and therefore they have taken the view that the full accrual method is appropriate. Subsequent events would have supported that management was making a reasonable assessment at the time.
- 8.39 He would consider himself a fairly creditworthy person except that he did select a very long term on a mortgage. The intention is that at the time he made the choice he felt that he was not going to hold it for a long time, market permitting, and therefore he would minimise his monthly payments because you would not want to increase your monthly payments if you are only looking at the short-term bridge financing. You cannot say because people are requesting an extension of a-hundred-and-eighty to two-hundred-and-forty it must mean that they are more risky. He is not going to guess what their intention is.
- 8.40 As an outside expert he would not assume that the fact that there were a-hundred-and-eighty, two-hundred-and-forty months would automatically mean

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they are high risk, that people intend to pay it over a-hundred-and-eighty or two-hundred-and-forty months. He would not make that assumption. There could be a lot of other things. It does not mean that people have a higher credit risk because they want longer payment terms. If that is given and he is not going to challenge that assumption, then it does increase the risk profile and it would then give stronger support to the use of the instalment method.

- 8.41 It is probably the quality of the purchaser more than the length of the payment terms which will be considered by management in terms of whether there is a risk of the purchasers not completing.

Re-examination

- 8.42 If the vendor retained title as security for repayments, it is just prudent business approach rather than a key consideration of risk in this case.

Finding and reasons

Accounting methods of recognition of revenue

9. There are two accounting methods for adoption for recognising revenue from the sale of properties:

- (a) Full accrual method. Under this method, revenue and profit from the sales are recognised upon the issue of an occupation permit or upon sale, whichever is the later. In the present case, the Taxpayer used the full accrual method to recognise revenue and profit from the sales of units of Property 1 under all the payment methods, including those under the IIP payment method (see paragraph 2(4)(c) above). No deferment of revenue or profit was made in the case of IIP sales in relation to unpaid consideration (see paragraph 6.3 above).
- (b) Instalment method. Under this method, revenue is recognised on cash payments made to the vendor by the purchaser who has chosen the IIP payment method, while profit is accounted for on the basis of cash received with reference to the percentage of gross profit to total sales value (see paragraph 6.4 above).

10. The choice of accounting method depends on the directors' decision to reflect which economic substance in the financial statements – performance of the property developer's act or the underlying credit risk of the sale (see paragraph 7.11 above).

11. The Taxpayer's directors adopted the full accrual method for all its sales, including those under the IIP payment method, in the preparation of its accounts for the year ended 30 June

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1996 (see paragraph 5.7 above), but elected to use the instalment method in preparing its profits tax return for the year of assessment 1996/97 to account for the instalments receivable attributable to IIP sales (see paragraph 7.8 above).

12. The instalments receivable at the balance sheet date comprised both instalments receivable attributable to IIP sales and those not so attributable. The formula used to calculate the profit to be deferred included, wrongly, instalments receivable not attributable to IIP sales. To exclude the receivables not related to IIP sales, the formula should be revised as follows (see paragraph 7.10 above):

$$\text{Profit on property trading} \times \frac{\text{Instalments receivable under the IIP sales}}{\text{Proceeds from sale of flats}}$$

13. A total of twelve units were sold by the Taxpayer under the IIP payment method up to 30 June 1996, out of a total of a-hundred-and-twenty units for the whole development. A summary of the sales of the twelve units is as follows:

| | |
|--|-----------------------------|
| | \$ |
| Total amount received by the Taxpayer by 30-6-1996 | 9,308,794.31 |
| Overdue and unpaid instalments as at 30-6-1996 | 333,671.90 |
| Instalments due and payable after 30-6-1996 (including \$1,443,757.70 due and payable within one year and \$71,170,707 beyond one year) | 72,614,463.79 |
| (Principal value) | Total: <u>82,256,930.00</u> |

(The total selling price for the twelve units sold under the IIP payment method)

14. Under the IIP payment method, payment of the purchase price would be spread over fifteen to twenty years. For nine out of the twelve units, the term agreed was two-hundred-and-forty months.

15. The Taxpayer's accounts for the year ended 30 June 1996 showed, among other things, the following:

- (a) instalments receivable : \$71,170,707;
- (b) current assets : instalments receivable : \$57,480.906; and

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- (c) profits before taxation : \$524,441,154 which included a profit on property trading of \$517,221,811. The latter figure was arrived as follows:

| | |
|-----------------------------|--------------------|
| | \$ |
| Sale of flats of Property 1 | 714,823,275 |
| <u>Less : Cost of sales</u> | <u>197,601,464</u> |
| Profit on property trading | <u>517,221,811</u> |

16. At the hearing, the Taxpayer through its counsel revised the amounts of profits and profits tax to be taken out in the tax computation as follows, using the revised formula at paragraph 12 above:

$$\begin{aligned} & \$517,221,811 \times \frac{(\$71,170,707 + \$1,777,430)}{\$714,823,275} \\ & = \$52,782,791 \text{ (amount of profits to be taken out)} \end{aligned}$$

The amount of profits tax to be taken out at 16.5% should be \$8,709,161.

17. These are the amounts of profits and profits tax which the Taxpayer says are in question. The Taxpayer concedes that the profits from units sold other than under the IIP payment method should be taxed in the year of assessment 1996/97.

18. The Taxpayer's accounts for the year ended 30 June 1996 were drawn up on the full accrual basis by bringing into the profit and loss account the whole purchase price as a receipt at full value on the day of the sale, including an IIP sale. However, for IIP sales, the profits tax computation was based on the instalment method, recognising revenue and accounting for profit on the basis of cash payments received (see paragraph 9(b) above).

Principle against anticipation

19. There is a principle against anticipation of both income and profits, but there is a difference between the two in terms of application of that principle.

20. The principle with regard to income is that it is taxable only when it is received. It is relied upon by the Taxpayer. Judicial pronouncements of this principle may be found in a line of cases including the following:

- 20.1 '... *receivability without receipt for income tax purposes is nothing at all ... Before a good debt is paid there is no such thing as income tax upon it*' (per Rowlatt J in Leigh v IRC [1928] 1 KB 73 at 77).

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- 20.2 *‘It appears to me that the reason why you make up the return for the particular year is that you look to see in the course of that twelve months what has been received, and it may be that a good debt will be paid in a subsequent twelve months and not in the twelve months in respect of which you are making your declaration, and you cannot anticipate that the money will come in its proper place in the following twelve months. I think Rowlatt J was right in saying that for income tax purposes receivability without receipt is nothing’* (per Lord Hanworth MR in Dewar v IRC [1935] 2 KB 351 at 367). (Emphasis supplied.)

When does a profit become taxable?

21. While income can only be taxed on a cash receipts basis, it is well settled that a profit may not be taxed until it is realised.

- 21.1 The principle referable to profits is expounded in Willingale v International Commercial Bank Limited [1978] AC 834. At 847 Lord Fraser of Tullybelton had this to say:

‘ For these reasons I am of opinion that the bank’s accounts prepared for commercial purposes are drawn up on the principle of anticipating future profits from its holding of bills and notes. There are no doubt excellent commercial reasons for preparing the accounts in that way: if I may borrow the words of Walton J [1976] 1 WLR 657, 663c, 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.”

But they are not a proper basis for assessing the bank’s liability to corporation tax.’

- 21.2 *‘ ... a profit may not be taxed until it realised. This does not mean until it has been received in cash but it does mean until it has been ascertained and earned’* (per Lord Salmon in Willingale v International Commercial Bank Limited [1978] AC 834 at 841).

- 21.3 *‘ The application of the principles of commercial accounting is, however, subject to one well-established though non-statutory principle. Neither*

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profit nor loss may be anticipated. A trader may have made such a good contract in year one that it is virtually certain to produce a large profit in year two. But he cannot be required to pay tax on that profit until it actually accrues' (per Lord Reid in BSC Footwear Limited v Ridgway [1972] AC 544 at 552, as quoted by Lord Fraser of Tullybelton in Willingale' s case at 843).

21.4 '*... it is a cardinal principle that profit shall not be taxed until realised'* (per Lord Reid in Duple Motor Bodies Limited v IRC [1961] 1 WLR 739 at 751, as quoted by Lord Morris of Borth-y-Gest in BSC Footwear' s case at 560, and quoted by Lord Fraser of Tullybelton in Willingale' s case at 843).

21.5 Australian and New Zealand tax legislation refers to income as being derived. Prichard J in Farmers Trading Co v CIR (NZ) 11 ATR 210 said at 218:

' ... for the purposes of the statute, income is derived when it has been "actually paid to or received" by the taxpayer or when it is "already due or receivable" ... To my mind ... income is derived only when it is received or when it accrues – that is, when it becomes due and payable.'

Again, at 224, he had this to say:

' There are two recent decisions of the House of Lords, which clearly support the concept that profit is to be brought into account only when it is received or when it accrues.'

He then referred to Lord Reid's dictum in BSC Footwear' s case cited in paragraph 21.3 above and continued at 224:

' I am persuaded that, for fiscal purposes, income is derived only when it "comes home", either in the form of actual payment or in the form of an accrual – an immediately enforceable right to receive payment. This is the principle recognised and applied, not only in New Zealand but also in Australia and the United Kingdom.'

22. From these judicial pronouncements, we consider that in terms of Hong Kong tax law, profit is realised when it is received or when it becomes due and payable, and that it becomes taxable when it becomes due and payable.

Taxability of instalments payable under the IIP sales

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23. The present case concerns profits rather than income. It follows that instalment overdue and unpaid under the IIP sales amounting to \$333,671 (see paragraphs 13, 16 and 17 above) should be brought into account in the year in question, because they are due and payable, and that the amount to be taken out as claimed by the Taxpayer should be reduced by deducting \$333,671 from \$1,777,430 in formula in paragraph 16 above.

24. The issue is whether the principle against anticipation applies to future IIP instalments not yet due and payable so that they should not be taxable in the year in question.

Trade debts

25. Trade debts are regarded as ‘one notable exception’ to the application of the principle against anticipation.

‘ ... A trader is not entitled to say: *You must not tax me on these debts because I have not received payment.* The Legislature says: *No, it is ordinary commercial practice in calculating your profits to bring in debts which are owing to you on the same basis as if they were receipts ... The reason why that exception is brought in is that it is in accordance with ordinary commercial practice to treat debts that way ...*’ (per Lord Greene MR in Johnson v WS Try Limited 27 TC 167 at 181).

Thus, trade debts are treated on a full accrual basis. However, future instalments payable over a long period of many years are in a different situation. The instalments, if practicable, should be valued and brought into account in the year of the sale, not at their face value, but at their actual value. If no satisfactory valuation is possible, then the instalments should be taxed in each year as they fall due (see Absalom v Talbot 26 TC 166 at 192).

26. The leading authority is Absalom's case. Mr Absalom in the years of assessment was engaged in the business of building industrial dwellings which he sold to members of the working class. The purchaser would agree to buy a house at a price, arrangements having already been made that a building society would advance to him a proportion of the price on a mortgage repayable by instalments over a period of years. The purchaser would provide a small sum in cash, which together with the amount provided by the building society would be handed over to Mr Absalom the builder on completion. For the balance of the price, Mr Absalom took a second mortgage payable with interest by monthly instalments over a period of more than twenty-two years. The agreement provided that the bargain to receive payment in instalments only lasts as long as the instalments are duly paid.

26.1 The issue is whether the future instalments payable to Mr Absalom over a period of years ought to be assessed on him for income tax in the year of the

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contract as profits of his trade for that year at full face value, or whether some other, and if so, what assessment should be made. At 191 of the Absalom case, Lord Atkin said:

‘ Now no one doubts that in ordinary commercial practice where goods are sold on terms of ordinary commercial credit, three or six months or even more, traders are in the habit of treating the debt so created as part of profits of the year in which the debt is incurred. Thus, where the business accounts are made up at the end of the calendar year, a sale in December on credit terms which expire in March or April will be regarded as a profit made in December. And this commercial practice is treated by taxpayers and collectors alike as involving a just and accurate computation of profits. The obligations so created in ordinary trade are treated as firm obligations and as good as cash in hand, and no one is any the worse. If expectations are disappointed, an allowance for a bad debt can be claimed and will be granted. But when one leaves the realm of ordinary commercial credits and has to deal with credits extending over many years, the whole situation is changed.

According to the Crown’s contention, it makes no difference whether the price of goods is to be paid forthwith or at the end of twenty years, or by instalments over twenty years, and whether with interest or not, nor apparently is the possibility or probability of the debtor being unable to continue the payments over the whole period a matter to be taken into account. To my mind, to treat money to be paid twenty years hence as producing a profit this year equal to money in fact paid this year is to produce a completely unreal conception of yearly profit, and I venture to think quite foreign to any commercial ideas on the subject...

It seems to me, therefore, in the present case, unreasonable to treat the whole sum payable over twenty years as amounting to a profit of the whole face value made in the year of sale.’

26.2 Lord Atkin then mentioned some considerations to be taken into account in calculating the profit in such cases as Absalom’s case:

- (a) Interest. The part of the instalments allocated to interest do not come into the calculation. But a sum payable by instalments at interest and fully secured either on mortgage of property or by the obligation of a debtor

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whose credit is beyond question, as a bank or large insurance company, might well be taken at its face value, for that would be the value of the obligation created. On the other hand, a sum payable without interest, either in a lump sum several years ahead or by instalments, could never be equivalent to its face value in the year of origin.

- (b) An obligation created by members of the working class, whose ability to pay depends upon continuance of employment, health and life, and is further burdened by an obligation to pay much larger sums in reduction of the mortgage to the building society, would very improbably be equivalent to the face value.
- (c) Questions under rule 3(i) of the rules applicable to cases I and II of schedule D (Rule 3(i)):
 - (i) Whether allowances for bad debts can only be made in the original assessment but not in subsequent years. The majority of the law lords, including Lord Atkin, are of the opinion that they can be made in subsequent years. In Hong Kong, the corresponding provisions of section 16(1)(d)(i) of the Inland Revenue Ordinance, by limiting the deductions to '*debts which were included as a trading receipt in ascertaining the profits ... of the period within which they arose*', seem to make it clearer than rule 3(i) that the allowances or deductions can be made in subsequent years.
 - (ii) The practice that once the creditor has gone out of business, no further allowances can be made. '*Thus the excessive assessment of the first year can no longer be compensated*' (Ibid 192).
 - (iii) The practice that when the creditor retires from business, income tax would no longer be chargeable on instalments received after that date (Ibid 193).

26.3 Lord Atkin's opinion, with which Lord Thankerton and Lord Russell of Killowen agreed, was that the case must go back to the Commissioners to adjust the assessment. As to method, valuation was preferred. The debt would be treated as an asset received in part discharge of the price, and its value would be calculated according to the experience of the business. Valuation may be made of each debt. In default of satisfactory valuation being possible, instalments should be taxed in each year as they fell due (ibid 193).

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27. The next authority is the Hong Kong case of CIR v Montana Lands Ltd (1968) 1 HKTC 334. Montana Lands Ltd (the company) carried on the trade of constructing and selling flats. Multi-storied buildings consisting of units of shops and flats were constructed on a plot of land acquired by the company. Shops and flats so constructed were offered for sale. Occasionally, some units were sold for cash but the majority of them were sold, at the request of the purchaser, under agreements for sale and purchase which provided, inter alia, the following:

- (i) The payment of a deposit on signing the agreement.
- (ii) Balance to be paid by monthly instalments over a number of years.
- (iii) Assignment of legal title will not be executed until payment of the final instalment.
- (iv) A forfeiture clause by which the company is entitled to forfeit all deposits or instalments paid and rescind the agreement upon default in the payment of instalments.
- (v) The purchaser shall be entitled to occupy the flat or shop he purchased before payment of the purchaser price in full.

A typical sample of clause 2 of the agreement provides:

‘ The purchase price shall be \$50,560 which shall be paid and satisfied by the purchaser to the vendors as follows:

\$10,000 Part thereof upon signing of this agreement.

\$3,600 To be paid by twelve equal calendar monthly instalments of \$300 each beginning from the first day of September 1963.

\$36,960 Balance thereof shall be paid by eighty equal calendar monthly instalments of \$462 each beginning from the first day of September 1964.’

27.1 In the company’s accounts for the year ended 31 March 1965, where flats or shops were sold on the instalment payment basis, profits were included only to the extent of profits in respect of that part of the sales price represented by the deposits and instalments received up to the end of the accounting year.

27.2 On 26 November 1965, the company’s tax representatives submitted the computation of liability to corporation profits tax for the year of assessment 1965/66, based on the accounts for the year ended 31 March 1965. In the

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computation, profits were likewise included only to the extent of profits in respect of that part of the sales price represented by the deposits and instalments received up to the end of the accounting year.

27.3 As explained by the company's tax representatives in a letter to the solicitor representing the company before the Board of Review:

(i) Where units were sold on a cash basis, all the profits were taken to account.

(ii) Where units were sold on an instalment basis, the profit taken to account was restricted to that realised on deposits and instalments received up to the balancing date, that is, 31 March 1965.

27.4 The usual form of contractual arrangement for sale on deferred terms contemplated a period of some eight years during which the purchaser would be paying off the amount of the purchase price by monthly instalments; completion did not take place until payment of the final instalment; although once the occupation permit was issued the purchaser was entitled to enter into occupation, he did so as a licensee only whose licence was dependent upon payment of future instalments as they fell due.

27.5 Time was to be of the essence of the contract in relation to the payment of the instalments; on default not only was the deposit to be forfeited but also all instalments already paid. It was pointed out on behalf of the Commissioner that these provisions, in effect, afforded security to the company for unpaid of future instalments, while the company took the point that falls in market value might well at any moment dissipate such security.

27.6 In the company's own business a long list has been produced to show defaulters who had backed out of the contract, in some cases by substituting other purchasers, and in other cases resulting in forfeiture of deposit; the property trend was such that there was every indication of a further deterioration in the market accelerated by the recent disturbances with the consequence of a even more material uncertainty of purchasers living up to their contracts.

27.7 The Board came to the conclusion that the method of computation employed by the company was in accordance with established accountancy principles, that it presented a balanced view of the company's affairs and a true commercial picture. It allowed the company's appeal.

28. Mills-Owens J, who heard the appeal from the Board of Review, reviewed the relevant

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authorities and continued at 366:

- (a) ‘ As I see it, none of them (ie, the authorities) bears directly upon the case before me, which is concerned with executory contracts, not completed transactions ... In the case of a sale and delivery of goods on credit the purchaser has obtained what he contracted for; the trader has discharged his obligation; the debt has accrued due; the transaction has been concluded, except only for the postponement of actual payment. In the present case the payments have not yet accrued due and the transactions remain to be completed. The fact that a purchaser of a flat may be allowed into possession does not alter that position or make it approximate to that of a purchaser of goods to whom credit is given. The purchaser of a flat does not contract for mere possession or occupation. He contracts for a title, in the form of a registrable deed of assignment of the property agreed to be bought and sold. It is not a case of measuring or assessing profits already earned or arising, but one in which the profits are in course of realisation, over a period.
- (b) *The present case, as I see it, is analogous to the case of an entire contract, where, as Lord Porter said in the Gardner Mountain Case, the remuneration is not earned until the whole task is completed. Likewise here, where the profit on the transaction is merely in course of realisation until actual completion. The fact that the purchasers of flats may become entitled to possession before actual completion makes no difference in the legal position, in my view; it cannot be held to convert an anticipated or expected profit into an actual profit. I see no analogy with the case of the trader selling, and delivering goods on credit; on the contrary, here the trader is receiving payment by instalments in advance of actual “delivery”.*’
(Ibid, 367)
- (c) ‘ It is difficult to be certain upon what legal basis trade debts are to be brought into account in the year in which they arise – whether it is by reason of the provisions of Rule 3 (now s 137 of the Income Tax Act, 1952) – or s 16(1)(d) – or by reason of commercial practice. Possibly, the better view is that the legislation recognises the commercial practice of bringing trade debts into account and is concerned to secure that allowance is to be made only for bad or doubtful debts. The judgments in the Absalom case both in the Court of Appeal and the House of Lords support that view. As I

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have said, the provisions of s 16(1)(d) of the Ordinance are worded differently from the English provisions. The proviso (i) to paragraph (d) limits deductions in respect of bad or doubtful debts to “debts which were included as a trading receipt in ascertaining the profits ... of the period within which they arose.” This appears to me to mean that in Hong Kong trade debts are recognised as brought into account as a matter of commercial practice, rather than by reason of some express or implied requirement of the Ordinance. If this is correct, as I think it is, certain remarks made by Lord Atkin in the Absalom Case which I have already cited, become pertinent. I refer to the passage in which he said that when one leaves the realm of ordinary commercial credits and has to deal with credits extending over many years, the whole situation is changed. That appears to me to be the position here so that the Board of Review was justified in taking the view which it did, that on commercial principles future instalments were not to be brought into account in the year in question.’ (Ibid, 368)

29. Mr Kotewall argues that Montana Lands is binding on the Board. Both that case and this case concern the sale of flats by instalments on credit extended over many years. Both are cases analogous to entire contract as the term was used by the learned judge, and completion of the contracts did not take place until the final instalment was paid. Ms Li, on the other hand, sought to distinguish Montana Lands, and named a few distinguishing features.

- 29.1 In Montana Lands there were no provisions for early termination by either party while here express provisions were made (see paragraph 2(9)(d), proviso to recital (c), clause 1(iv) and clause 2(a) above). However, we do not see the express provisions having the effect of putting the credit given outside the realm of ‘credits extending over many years’ (see paragraph 28(c) above).
- 29.2 Here, the Taxpayer has done everything short of executing the assignment but it is not shown in Montana Lands that the vendor had already shown good title. But the Taxpayer’s argument is that in both cases, the vendor would only complete, and title would only pass, when the final instalment was paid, and that both are therefore cases analogous to entire contract.
- 29.3 (1) In Montana Lands, the instalments did not fluctuate while in the present case instalments were linked to the prime rate;
- 29.4 (2) In Montana Lands there was produced a long list of defaulters, but in the present case there have been no defaulters;

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29.5 (3) In Montana Lands, the directors adopted the cash receipts accounting method, while, in the present case, they chose the full accrual accounting method and even paid a dividend;

29.6 (4) In Montana Lands there was evidence of a recession in the property market and further deterioration was expected.

30. In our view, with the exception of the point in paragraph 29.3(3) above, with which we shall deal in paragraphs 34-37 below, none of the differences mentioned in paragraph 29 above is sufficient to distinguish Montana Lands from the present case.

Should we follow Montana Lands or Absalom?

31. In Montana Lands, the directors adopted the cash receipt basis to account for the profits from sales on an instalment payment basis in the company's financial statements for the year in question. They also used the same basis in computing its tax liability for that year. The accounting treatment and the tax computation are perfectly consistent. The learned judge approved the accounting treatment as being in accordance with commercial principles. Although there was no express approval of the tax computation, he must be taken to have approved it by implication. He treated the sale and purchase agreements as executory contracts, and not completed transactions, because under the agreement, completion was to take place when the occupation permit came to be issued, all instalments being duly paid. The profit on the transactions was regarded as being merely in course of realisation until actual completion. He therefore approved the Board's view that on commercial principles future instalments were not to be brought into account in the year in question (see paragraph 28(a) to (c) above).

32. The issue with which the House of Lords dealt in Absalom was of the same nature. There the issue was whether the future instalments payable over a period of years should be assessed to tax in the year of the contract as profits of the taxpayer's trade for that year at full face value, or whether some other, and, if so, what assessment should be made (see paragraph 26.1 above). Lord Atkin's opinion, with which Lord Thankerton and Lord Russell of Killowen agreed, was that the assessment should be adjusted, preferably by valuation of the debt as an asset received in part discharge of the price, and that in default of satisfactory valuation being possible, the instalments should be taxed in each year as they fell due (see paragraph 26.3 above).

33. We would hold ourselves bound by Mr Justice Mills-Owens' judgment in Montana Lands because: (1) the basis for the decision in Montana Lands was that title only passes upon payment of the final instalment (see paragraph 28(a)-(c) above), (2) likewise in the present case, title only passes upon payment of the final instalment and (3) Montana Lands is a Hong Kong authority and therefore binding. However, we are precluded from deciding this appeal by following Montana Lands by reason of the appropriation and payment of a dividend by the Taxpayer in the year in question.

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The interim dividend

34. It was stated in the Taxpayer's directors' annual report for the year ended 30 June 1996 and dated 11 September 1996 that an interim dividend of \$430,000,000 was declared and paid during the year. As recorded in the Taxpayer's audited accounts for that year, the dividend was appropriated and paid out of profit after taxation (less accumulated losses) amounting to \$437,377,404, leaving retained profits of \$7,377,404.

35. The Taxpayer's accounts were prepared on the basis of the full accrual method, with the result that profits from all sales in the year, including those on the IIP basis (that is, sales of the twelve units) were brought into account to tax, and that the profit after taxation (less accumulated losses) amounting to \$437,377,404, out of which the dividend was paid, had the profits from the twelve units as one of its sources. If, as claimed by the Taxpayer, the twelve units' profits were taken out of the accounts, the profit after taxation (less accumulated losses) would fall short of the amount of the interim dividend by \$36,801,147, as shown in an unchallenged calculation by Ms Li:

Adjusted profit if profit from the twelve units were excluded

| | As Reported | Adjusted |
|--|--------------------|-----------------|
| | \$ | \$ |
| 1 Profits relating to the twelve units sought to be excluded | | 52,782,791 |
| 2 Sale of flats | 714,823,275 | |
| 3 <u>Less</u> : Cost of sales | (197,601,464) | |
| 4 Profit on property trading | 517,221,811 | |
| Adjusted (=4-1) | | 464,439,020 |
| 5 Profit/(loss) before taxation | 524,441,154 | |
| Adjusted (=5-1) | | 471,658,363 |
| 6 Taxation @ 16.5% x 5 | 86,427,870 | 77,823,630 |
| 7 Profit/(loss) after taxation (=5-6) | 438,013,284 | 393,834,733 |
| 8 Accumulated loss at 1 July | (635,880) | (635,880) |
| 9 Profit available for appropriation (=7-8) | 437,377,404 | 393,198,853 |
| Appropriation | | |
| 10 Interim dividend paid | 430,000,000 | 430,000,000 |
| 11 Retained profits/(accumulated losses) at 30 June (=9-10) | 7,377,404 | (36,801,147) |

36. After the interim dividend of \$430,000,000 was paid, only a balance of \$7,377,404 was left as retained profits. In our view, the profits from the twelve units, having been used,

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together with profits from the other units, to make up the dividend which was paid, cannot still be deemed to be profits to be taken out of the profit and loss account in computing profits tax. Put another way, once the dividend of \$430,000,000 is paid, it is no longer open to the Taxpayer to prepare another set of accounts for tax purposes in order to exclude the twelve units' profits, for that would mean that the Taxpayer has overpaid the dividend by \$36,800,000, a thing which it cannot lawfully do.

The authorities relied upon by Ms Li include the following which we will follow:

36.1 Chancery Lane Safe Deposit and Offices Co Ltd v IRC [1966] AC 85

' If a company makes and adheres to a decision that a payment should be out of capital and orders all its affairs on that basis, it would be strange if it could assert that the payment should be deemed to be one payable out of profits or gains ... If a payment is attributed to capital, the practical result follows that the sum available or carried forward as available for distribution by way of dividends is increased ... It would be incongruous, however, if a company, having decided ... to charge a payment to capital and having regulated its proceedings on that basis, could say that the payment was not to be deemed to be charged to capital ... what was in fact and in reality a payment out of capital cannot be paraded in the guise of a payment out of revenue. That would be more than departing from documents or accounts: it would be departing from fact: it would be a distortion of history' (per Lord Morris of Borth-y-Gest, at 118-119).

' There was a deliberate choosing of attribution to capital rather than to revenue. It was not a matter of method of domestic book-keeping. The accounts merely evidenced the fact that a decision was taken, was acted upon and was maintained. The company's definite attribution precluded an entirely inconsistent attribution. The company had deliberately elected to charge the interest against capital' (per Lord Morris of Borth-y-Gest, at 122).

36.2 BW Nobes & Co. Ltd v IRC [1966] 1 WLR 111

From 1958 to 1966, company N, the appellant, paid annual payments within the meaning of the Income Tax Act of 1952 to company A. In each of the relevant years company N paid dividends to its shareholders. In each of the relevant years the taxed profits of company N were sufficient to cover the annual payments, but not both the annual payments and the dividends, both of which were paid under deduction of tax. In company N' s accounts the annual

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payments were shown as balances against the capital receipts from company C and the dividends were shown as payments out of current profits. If the annual payments were ‘payable wholly out of profits or gains brought into charge to tax’, then it followed, pursuant to section 169 of the Act, that company N could retain the tax deducted: if the payments were not so payable or not wholly so payable, then it followed, pursuant to section 170, that company N was assessable. The question is whether company N has the right to retain the tax deducted from the annual payments or must account for it to the Revenue.

‘ *The facts in the present case show that there was a clear decision to make the annual payments out of capital. That decision was maintained and was acted upon year after year. The decision of the special commissioners that the annual payments were in fact made out of capital was one that was manifestly supported by the evidence. The company so acted as to preclude themselves from attributing the annual payments to the taxed profits ... This was not a matter of method of account-keeping or book-keeping. Though the figure of profits or gains brought into charge to tax is a notional figure, it is to be remembered that when annual payments are made or when tax is paid or when dividends are paid, there have to be actual payments out of some actual fund or source of payment. In the profit and loss and appropriation accounts of the company for the years in question, the annual payments did not appear: that was because they were made with capital sums. The mere form of accounts would not be decisive, but the accounts were evidence of a decision upon which action was taken which had positive results and which affected the rights of others. Resolutions as to dividends were passed and were acted upon in reference to accounts which had as their basis that the annual payments were made out of capital and accordingly would not diminish the fund available for distribution. The company elected to pay dividends out of its annual profits as so computed. The facts could not later be altered. If the annual payments had been made out of the annual profits the position of the shareholders would have been altered ...*’ (per Lord Morris of Borth-y-Gest, at 115-116).

‘ *The mere fact that the annual payments were, in the company’s books, dealt with in a special account and set against the capital sums received from [company C], and were not brought into the profit and loss account where the company’s taxed profits appeared, would not of itself prevent the company from claiming the benefit of section 169 of the Income Tax Act: there would (to use the accepted expression) be a domestic piece of book-keeping by which the company would not, as*

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against the Revenue, be bound. But the payment of dividends, expressed to be after deduction of tax, out of the taxed profits in each year, would, in my opinion, beyond doubt have deprived the company of the benefit of the section’ (per Lord Wiberforce at 117). (Emphasis supplied.)

‘ ... In my opinion, therefore, the attempt of the company to provide, *ex post facto*, cover for the dividends paid does not succeed: the position remains that the dividends were paid out of the taxed profits ... with the result that the annual payments must be treated as paid from another source’ (per Lord Wilberforce at 119).

36.3 Princes Investments Ltd v IRC [1967] 1 Ch 953

‘ Dividend A received by New Century on March 24 1957, was its only source of “actual income” for the year 1956-57 ... the only question to be answered is: “Was the dividend of £14,000 declared by New Century to Princes Investments on March 28 1957, paid out of dividend A?” Or, put another way, “Did or could New Century appropriate dividend A to the payment of its own dividend paid on March 28 1957?” We agree with the judge that the answer is “No”. Dividend A is no longer available for that purpose. By November 1 1956, the date of New Century’s accounts for the year 1955-56, it had already been appropriated by those accounts to the reduction of the debit balance on profit and loss account. New Century’s accounts for the year 1956-57 show that it was dividend B which was appropriated, in anticipation of its actual receipt, to the payment of New Century dividend of £14,000 gross on March 28 1957. This was not merely as a matter of internal book-keeping. So long as it was, it would have been open to the directors to change their minds. But as soon as their decision was recorded in their published accounts (as it was on November 1 1956) the die was cast.

As so recorded, the decision had practical effects as regards creditors and members of the company. It showed the assets of the company as enhanced by £8,321, a sum which was no longer available for distribution to its members, and was thus available for creditors. Once this had been done, it was, in our view, no longer open to New Century to attribute dividend A to any other purpose, or to claim that its own dividend in the following year was paid out of it: see Chancery Lane Safe Deposit v IRC’ (per Diplock LJ at 989-990).

37. The declaration and payment of the dividend had positive results: the shareholders received the benefit of the dividend. Its payment is in our view a fact which cannot be altered (see

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paragraph 36.2 above). The sources of the payment included the profits from the twelve units. The accounts were prepared on the basis that the profits after taxation were sufficient to pay the interim dividend of \$430,000,000. All this is history which cannot change. The twelve units' profits, having been treated as part of the fund (that is, the profits after taxation) out of which the dividend was in fact paid, cannot in our view be excluded in another set of accounts for taxation purposes. The Taxpayer is therefore precluded from claiming, as against the Revenue, that the twelve units' profits should be taken out in accounting for the profits for the year in question.

Conclusion

38. It follows that this appeal is dismissed and that the assessment in question is hereby confirmed.