Case No. D12/86

Board of Review:

H. F. G. Hobson, *Chairman*, D. Evans and T. Y. Tse, *Members.*

4 July 1986.

Profits Tax—whether loss on scrapping certain carpets and loss on the sale of other carpets "expenses" within the meaning of Section 16(1) of the Inland Revenue Ordinance so as to qualify for deduction from taxable profits.

The Appellant is a service company providing services including the provision of furnished offices and residential premises. In 1976 the Appellant provided carpets for an apartment and in 1979 some of these were scrapped and replaced by new carpets. The deduction for the replacement costs was allowed under S. 16(1)(*f*) of the Inland Revenue Ordinance but the Appellant claimed deduction for losses on scrapping and on the sale of the carpets bought in 1976. The Assessor refused the claim. The Appellant appealed.

Held:

The carpets, having once been capital, are a loss of capital when no longer of use and hence are caught by Section 17(1)(*c*) of the Inland Revenue Ordinance and, not being in the nature of replacements, are not subject to relief.

Appeal dismissed.

Wong Chi-wah for the Commissioner of Inland Revenue.
B. Fludder of Touche Ross & Co. for the Appellant.

Reasons:

The Appellant appealed to the Board against a Profits Tax Assessment for the year 1981/82. The Appellant is a service company which, pursuant to a contract with a firm of accountants (the "Firm"), provides services to the Firm, including particularly the provision of furnished offices and residential premises for the Firm's staff.

The Appellant's dispute with the Revenue turns on whether the loss on scrapping certain carpets (Case A) and the loss on the sale of other carpets (Case B) supplied by the Appellant for use by the Firm, are "expenses" within the meaning of section 16(1) so as to qualify for deduction from taxable profits of the Appellant.

1. Background

1.1 In 1976 the Appellant bought carpets for an apartment at a cost of $19,739.

1.2	In October 1979 some of these were scrapped.	
1.3	In November 1979 it replaced some at a cost of	$9,324
1.4	In July 1980 it replaced the balance for	$4,002
	Total:	$13,326

1.5 In January 1981 the Appellant sold some other carpets which were used in the Firm's office premises en bloc together with certain other items. The Appellant attributed a sum of *$2,849* as the loss suffered with respect to the carpets.

Case A—loss on scrapping

Revenue allowed that 1.3 and 1.4 above qualified for deduction by virtue of s. 16(1)(*f*): and the Appellant did not object. In effect both sides were thereby agreeing that the carpets were "… articles employed in the production of profits" which seems to us to be correct because if the Firm wants the carpets the Appellant must supply them as a prerequisite to earning its fee from the Firm. The supply of the carpets is an income producing activity.

The Appellant attributed 40% of the original cost to the replaced carpets and hence 60% to scrapped carpets, i.e. *$11,843*, referred to at 1.2 above.

Case B—loss on sale

The only reason for distinguishing this loss from Case A is that where items are sold in one bargain, some of which qualify for allowances and others do not, the Commissioner shall apportion the sale proceeds amongst the items concerned (s. 38A). Mr. Fludder, who appeared for the Appellant, claims that the Commissioner failed to do this. Subject only to this Mr. Fludder's arguments are, in principle, the same for both Case A and Case B.

Capital or Expense?

Were the carpets capital assets? That is the question we have to decide. If they were then although the Ordinance allows a deduction for their replacement (s. 16(1)(*f*)) it not only specifically prohibits a deduction in s. 17(1)(*c*) but grants no allowances under the Inland Revenue Rules.

The Relevant Provisions

s. 16(1): "In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of

assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period, including—…"

s. 17(1)(*c*): "For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of—

(*c*) any expenditure of a capital nature or any loss or withdrawal of capital;"

Inland Revenue Rules: "2. (1) For the purpose of the Ordinance, the expression 'machinery or plant' shall include or be deemed to include the items specified in the second column of the First Part of the Table annexed to this rule but not the items specified in the second column of the Second Part of that Table which shall be deemed to be included in the expression 'any implement, utensil and article' for the purposes of the Ordinance.

(2) The rates of depreciation specified in the third column of the First Part of the Table annexed to this rule are hereby prescribed for the purpose of ascertaining the annual allowance to be made under section 37(2), 37A(2) and 39B(3) of the Ordinance.

TABLE

FIRST PART

12. Furniture (excluding soft furnishing) … 20%

SECOND PART

6. Soft furnishings (including curtains and carpets.)"

Appendix II to the Report of The Inland Revenue Ordinance Committee 1954 (which is headed "Suggested Minor Amendments"):

"19. Make provision for the cost of replacing small items of capital equipment to be charged against profits provided the articles do not rank for allowance under Part VI." Part VI is concerned with depreciation allowances.

2. The Appellant's Argument

2.1 Granted the carpets were shown in the Appellant's balance sheets as "fixed assets" but that is not conclusive since there really was no other suitable category in the accounts to which these items could be assigned. They could not be put in the Profit and Loss Account until the loss (or for that matter profit in the unlikely event that a sale produced a profit) occurred—whether such occurrence was a result of a sale or of abandonning the article. The cost of the carpets was in the nature of *prepaid expenses.*

2.2 Mr. Fludder submitted that, under section 16 and 17 of the Ordinance, the use of the word "expenditure" carried and is intended to carry a different meaning to the use of

the word "expenses". The former implies that payment for the article arises, the latter is not necessarily concerned with payment having been made either in the year in which the deduction is permitted (as for example provision for staff retirement benefits—see Lo and Lo HKTC Vol. 2 p. 34) or indeed with payment at all (for instance, depreciation or where there is an exchange of items rather than a sale).

Thus the word "expenses" has a wider connotation than expenditure: the words are not synonymous. The argument runs that although the "expenditure" for the carpet cannot be deducted when incurred because of s. 17(1)(*c*), it will qualify for deduction under s. 16(1) at the time when the carpet is sold or scrapped. The grounds are that the proceeds on disposal represent a shortfall from the original purchase cost, deemed to be an "expense" of the carpet consumed during the period from the time it is purchased up to the time when it is sold or scrapped. Mr. Fludder further maintained that the shortfall does not fall within the meaning of "… any loss of withdrawal of capital" as specified under s. 17(1)(*c*).

2.3 The list of deductions at (*a*) to (*h*) of s. 16(1) are merely illustrative of allowable "outgoings and expenses". The list is not exhaustive, consequently any unlisted expense should qualify so long as it is not blocked by section 17. The carpets, Mr. Fludder contended, were not finally of a capital nature.

The balance sheet holds consumable assets in suspense (or "on the bridge" in Mr. Fludder's terminology) until they metamorphose into expense, by being scrapped or otherwise disposed of. Once they are expense, these items are allowable under section 16 and not disallowable under section 17.

3. Revenue Arguments

3.1 By its own admission the Appellant "capitalized" the initial expenditure on the carpets in 1976. Certainly the carpets did not form part of the Appellant's stock-in-trade. The expression "prepaid expenses" has a technical meaning viz:

> a prepaid expense is an expense paid but not yet incurred (i.e. to yet recognized). A prepaid expense occurs when a company has paid for services or *supplies* that are not used, or *consumed*, by the end of the accounting period."

Mr. Wong chi-wah (Assessor, Appeals of the IRD) submitted that the carpets were not "supplies"—certainly not recurrent supplies in the *accepted* meaning. Mr. Fludder's contention that the carpets were "consumed" is of no help since it begs the primary question—are the carpets "supplies".

3.2 Mr. Fludder had introduced a novel argument of a revolutionary character "subversive of the basic principles dear to the accountant's heart", to quote Mr. Wong.

3.3 Notwithstanding Mr. Fludder's arguments Mr. Wong submitted that as far as *deductions* under s. 16 and s. 17 are concerned there is no effective difference between "expenditure" and "expense".

So much then are the relative arguments.

It is our view that expenditure encompasses outlay whether capital or revenue and hence as a different meaning from expense, which is revenue but not capital and may or may not be expenditure. To speak of capital and may or may not be expenditure. To speak of capital expense is a contradiction in terms. Capital items may be written off to profit and loss account, at once, in instalments or in due course, but essentially this is recognition of a loss of capital.

After the blanket disavowal of section 17(1)(*c*), the IRO nevertheless provides some relief for assets under Part VI and 16(1)(*f*).

The carpets in this case, having once been capital are a loss of capital when no longer of use and hence are trapped by 17(1)(*c*) and, not being in the nature of replacements, are not subject to relief.

We are unable to see the logic, other than possibly the practicality of accounting for small articles over a period of time, of the IRO restricting relief of such articles of a capital nature to replacement items while assets which qualify under Part VI are fully relieved.

Mr. Wong referred us to the Inland Revenue Review Committee recommendation quoted above but the report does not indicate the reasons for the recommendation that replacement costs be allowed but it should be noticed that the recommendation refers to "replacing small items of *capital equipment*"—though these last two words were not adopted when the amending legislation was passed. Since the Appellant accepted without demur the application of s. 16(1)(*f*) (see under heading—Case A—loss on scrapping—above) then it can be reasoned (perhaps unfairly) by the application of hindsight, that the Appellant cannot now be heard to argue that carpets are not "capital equipment".

However, disregarding the last point, we turn to the argument that the costs of their purchases are prepaid expenses. We cannot accept that this is an appropriate description for articles consumed by wear and tear, and note that they not have been so categorized in the appellant's balance sheet.

As to the question of "supplies" referred to at 3.1 above, no definition was offered to us by either party as to what the word "supplies" means but to our mind it suggests something which is used up within a relatively short period of time, as for instance raw materials used up when converted or integrated into a product in the course of manufacture rather than something which over possibly a number of years wears out.

We therefore find as a mixed question of fact and law that the carpets were in the nature of capital.

As to Mr. Fludder's point concerning s. 38A we do not accept, as Mr. Fludder contended, that the Commissioner, if he were going to rule that carpets were capital, was duty bound not to accept the Appellant's attribution of $2,849 but to use some lesser figure to ensure that the Appellant would bear a smaller tax burden. The Appellant itself had chosen the figure of $2,849 the Commissioner had tacitly accepted it and thereby satisfied s. 38A.

Mr. Fludder has also expressed the view that there cannot have been a loss of capital as the company remains with its subscribed capital intact. We cannot see that this argument carries weight as a capital loss can be offset by profit.

Although it was also submitted as a ground of appeal that the assessed profits exceed the company's actual profits since inception, this is not unexceptional in the operation of a taxing statute.

For the foregoing reasons we dismiss this appeal.

Mr. Fludder referred to certain Australian cases but we did not consider them to be of any assistance, in part because the Lo & Lo Privy Council decision now makes it clear that one of the cases referred to (New Zealand Flax) has no application in Hong Kong.