

Case No. D19/07

Profits tax – assessable profits in relation to incomplete long term contracts – sections 14(1) and 68(4) of the Inland Revenue Ordinance ('IRO') – Departmental Interpretation and Practice Note ('DIPN') No 1.

Panel: Colin Cohen (chairman), Clement Chan Kam Wing and William Tsui Hing Chuen.

Date of hearing: 24 July 2007.

Date of decision: 24 August 2007.

The taxpayer carried on the business of professional management, design and installation in the fields of architectural, structural, mechanical and electrical engineering and contracting. The taxpayer recognized profits from incomplete contracts on the basis of the percentage of completion method in accordance with the Generally Accepted Accounting Practice (GAAP). Yet for taxation purposes, the taxpayer contended that they were entitled to choose between the percentage of completion method and the completed contract method. The taxpayer emphasized that they relied very heavily upon the 1976 DIPN No 1.

Held:

1. The authorities with regard to ascertaining the taxable profits are clear and unequivocal in that a person's profits for taxation purposes must be ascertained in accordance with ordinary principles of commercial accountancy. It is accepted that no modification is required or permitted unless they conflict with the IRO. The IRD and the taxpayer are bound by the latter's choice of accounting treatment. The taxpayer's accounts were approved by its directors and certified by its auditors as having been prepared in accordance with the proper accounting principles generally accepted in Hong Kong. Therefore, in accordance with the GAAP, the taxpayer recognized profit from incomplete long term contracts on the basis of the percentage of completion method. The taxpayer is clearly bound by its accounting treatment and is not entitled to adjust or modify its assessable profits by way of a computational adjustment on the basis of the completed contract method.
2. It is quite clear that the information contained in the DIPNs are only for information and guidance of taxpayers and their authorized representatives. It has been made

clear that these practice notes have no binding force and do not affect a person's right of objection or appeal.

Appeal dismissed.

Cases referred to:

The CIR v Secan Ltd & Ranon Ltd [2000] 5 HKTC 266
Odeon Associated Theatres Ltd v Jones [1972] 48 TC 257
Gallagher v Jones [1993] STC 537
CIR v Secan Ltd & Another [2000] 3 HKCFAR 411
D110/98, IRBRD, vol 13, 553
D54/06, (2006-07) IRBRD, vol 21, 1037
HKSAR v Hung Chan Wa & Another, CACC 411/2003

Taxpayer represented by its directors.

Fung Chi Keung, Chan Man On and Leung To Shan for the Commissioner of Inland Revenue.

Decision:

Introduction

1. Company A ('the Taxpayer') has objected to profits tax assessment for the years of assessment 1997/98 and 1998/99. The Taxpayer was incorporated as a private company in Hong Kong on 8 August 1995 and at all relevant times, the Taxpayer carried on the business of professional management, design and installation in the fields of architectural, structural, mechanical and electrical engineering and contracting. On various dates, the Taxpayer filed profits tax returns together with audited financial statements and profits tax computations for the relevant years of assessment 1996/97 to 1998/99.

The issue

2. The relevant issue for our consideration is how to compute the Taxpayer's assessable profits under the Inland Revenue Ordinance ('IRO') in relation to profits for some incomplete long term contracts.

3. The Taxpayer however has recognized profits from incomplete contracts on the basis of the percentage of completion method in accordance with the Generally Accepted Accounting Practice ('GAAP'). Yet, for taxation purposes, the Taxpayer contends that they are entitled to

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choose between the percentage of completion method and the completed contract method.

4. The Taxpayer has drawn to our attention the fact that there are two sets of accounts that they are entitled to rely on. Company B, a firm of certified public accountants has been the Taxpayer's auditors for the relevant years of assessment. In their audit reports, Company B certified that the Taxpayer's accounts gave a true and fair view of the state of affairs as well as the profits and loss for these years. In those accounts, the Taxpayer recognized profits from long term contracts under the percentage of completion method in accordance with GAAP. However, the Taxpayer in their profits tax computation put forward a different calculation with regard to calculation they assert they are entitled to rely on the completed contract method. Hence, the issue for us to consider is whether or not the Taxpayer's assertions are indeed correct.

5. The Taxpayer at the hearing before us was represented by its Executive Director, Mr C.

The evidence

6. The following facts were agreed by the parties and we find them as facts:

1. The Departmental Interpretation and Practice Notes ('DIPN') No 1 was issued in July 1976 ('1976 DIPN 1').
2. On 8 September 1997, Deputy Commissioner of Inland Revenue ('DCIR') replied a firm of certified public accountant's enquiries, clarifying a misconception of paragraph 4 under Part B of the 1976 DIPN 1. She clarified that this paragraph was intended to convey the message that if a taxpayer took up profits on long-term contracts in his accounts on 'the percentage of completion' basis, the profits so recognised would have to be adopted for tax purposes. It was not intended for the taxpayer to exclude such profits, for tax purposes, by a computational adjustment, on the ground the 'completion' basis should be applied for such purposes.
3. On 15 September 1997, Assistant Commissioner, Unit 1 issued a circular to his assessors on 'Taxability of Profits from Long Term Building and Engineering Contracts'. He mentioned DCIR's letter dated 8 September 1997 and issued assessing instructions on this matter. He said that there was no change in the departmental practice.
4. The Company filed its 1996/97 profits tax return on 4 February 1998 on the basis of returning profits attributable to long-term contracts for tax only upon the completion of those contracts ('completed contract method'). The profits recognized on incomplete contracts ('PIC') in financial accounts were

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excluded (that is, deferred) for tax purpose until the contracts reached completion.

5. The accounting standard SSAP 23 was introduced in May 1998 which superseded SSAP 3.
6. On 20 August 1998, the assessor issued an enquiry letter to the Company's tax representative, Company B, in respect of the year of assessment 1996/97, which included, among other things, the reasons why the profits on incomplete jobs were recognised in the profit and loss account on the one hand but claimed to be unrealized in the tax computation.
7. The IRD issued the revised DIPN No 1 ('1998 DIPN 1') in October 1998.
8. The Company filed its 1997/98 profits tax return on 1 February 1999 based on completed contract method.
9. On 26 March 1999, Company B replied the assessor's enquiry letter dated 20 August 1998.
10. The Company filed its 1998/99 profits tax return on 15 November 1999 based on completed contract method.
11. On 3 February 2000, the assessor issued a statement of loss to the Company for the year of assessment 1996/97, which included the PIC as recognised in the Company's financial accounts.
12. The Court of Final Appeal delivered the judgement of The CIR v Secan Ltd & Ranon Ltd [2000] 5 HKTC 266 ('Secan Case') on 8 December 2000. In page 7 of the CIR's determination, the IRD has referred to the decision of Secan Case:

'Both profits and losses therefore must be ascertained in accordance with the ordinary principles of commercial accounting as modified to conform with the IRO. Where the taxpayer's financial statements are correctly drawn in accordance with the ordinary principles of commercial accounting and in conformity with the Ordinance, no further modifications are required or permitted.'
13. The IRD issued the notices of assessment for 1997/98 and 1998/99 on 21 March 2002.

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14. The Company lodged an objection against the notices of assessment for 1997/98 and 1998/99 on 19 April 2002.
15. During the period from 2 May 2002 to 22 May 2006, numerous correspondence were exchanged between the assessor and Company B, in relation to, among others, the taxability of PIC.
16. The assessor did not agree with Company B's contentions. On 6 October 2006, the assessor referred the Company's objection to the Commissioner for determination.
17. The Deputy Commissioner of IRD issued the determination and statements of facts on 16 January 2007.
18. On 6 & 7 February 2007, there were telephone discussions between Company B and the assessor. Company B wished to seek a compromise settlement with the IRD. The assessor declined it and said that the determination was correctly decided as a matter of law and in accordance with IRD's practice.
19. The Company filed the Notice of Appeal of the Board of Review ('BoR') on 15 February 2007.
20. On 16 May 2007, there was a telephone discussion between Company B and the assessor. The assessor repeated that there was little scope for compromise as the assessments were correct in law and made in accordance with IRD's practice.
21. On 18 May 2007, the assessor issued the Revenue's bundles of documents and authorities in accordance with the BoR's direction.
22. The Company's tax representatives submitted a compromise settlement proposal to the IRD on 10 July 2007, in which the Company submitted various new arguments to support the Company's position, and proposed to reach a settlement with the IRD before the BoR hearing. The IRD rejected the Company's request in their letter dated 12 July 2007.
23. On 12 July 2007, Company B (Ms D, Senior Tax Manager) rang the assessor (Mr Fung Chi-keung, Senior Assessor) and said it was undesirable that the Company did not know IRD's position. The assessor explained that the Secan case merely reaffirmed the general principle that taxation profit should follow accounting profit, which had been adopted in earlier cases such as the Odeon

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(1973) and Gallagher (1993) cases. IRD's DIPN was issued for guidance and had no binding force. In any event, the 1997/98 and 1998/99 assessments were raised in March 2002 in accordance with IRD's assessing practice stipulated in the 1998 DIPN 1. The prevailing practice mentioned in sections 70A(1) and 60(3) of the IRO were irrelevant to the present appeal. The assessor said there was no dispute of facts or figures and only one technical point was involved, it was the IRD's established practice of not issuing a statement of fact for simple case.

24. On 17 July 2007, the assessor discussed with and faxed a letter to Company B, advising that there was no change in IRD's assessing practice in 1998.
25. The Company issued a letter to BoR on 18 July 2007 to explain the reasons for the delay in submitting the comments to the statements of facts issued by the IRD.

7. Mr C gave evidence. He informed us that he was the Executive Director and one of the main shareholders of the Taxpayer. He is an Architect by profession. He drew to our attention that the Taxpayer's business was previously carried out by other entities in other forms by way of limited companies and/or partnerships. He drew to our attention that previously the IRD had accepted the relevant profits tax returns but he asserted to us that these were on a completed contract method. However, no evidence was adduced before us to support such a contention nor did the Taxpayer submit any documentation in support of such an assertion. During the course of his evidence, he emphasized that he relied very heavily upon the 1976 DIPN 1.

8. On cross-examination, Mr Fung on behalf of the IRD asked whether or not the Taxpayer had filed tax computations that had previously been accepted by the IRD on a completed contract method. Mr C responded that he could not answer this question. He stated that '..... I don't really know off the top of my head. I would have to look back on the records. I can't answer that directly.'

Our analysis

9. Section 14(1) of the IRO provides that profits tax shall be charged on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong from such trade, profession or business.

10. The authorities with regard to ascertaining the taxable profits are clear and unequivocal in that a person's profits for taxation purposes must be ascertained in accordance with ordinary principles of commercial accountancy. It is accepted that no modification is required or permitted unless they conflict with the IRO. The IRD and the Taxpayer are bound by the latter's choice of accounting treatment.

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11. In Odeon Associated Theatres Ltd v Jones [1972] 48 TC 257, Sir John Pennycuick stated as follows at page 555g-h:

‘The concern of the Court in this connection is to ascertain the true profit of the taxpayer. That and nothing else, apart from express statutory adjustments, is the subject of taxation in respect of a trade. In so ascertaining the true profit of a trade the Court applies the correct principles of the prevailing system of commercial accountancy ... Having done so, it will ascertain the true profit of the trade according to that principle, and the profit so ascertained is the subject of taxation.’

12. In Gallagher v Jones [1993] STC 537, Sir Thomas Bingham MR reviewed a number of authorities including the case of Odeon Associated Theatres Ltd v Jones and stated as follows:

‘... The object is to determine, as accurately as possible, the profits or losses of the taxpayers’ businesses for the accounting period in question. Subject to any express or implied statutory rule, of which there is none here, the ordinary way to ascertain the profits or losses of a business is to apply accepted principles of commercial accountancy. That is the very purpose for which such principles are formulated. As have often been pointed out, such principles are not static: they may be modified, refined and elaborated over time as circumstances change and accounting insights sharpen. But so long as such principles remain current and generally accepted, they provide the surest answer to the question which the legislation requires to be answered ...’

13. The Hong Kong Court of Final Appeal in CIR v Secan Ltd & Another [2000] 3 HKCFAR 411 again reaffirmed the relevant principles. Lord Millet NPJ stated as follows at 419C-F:

‘... Both profits and losses therefore must be ascertained in accordance with the ordinary principles of commercial accounting as modified to conform with the (IRO). Where the taxpayer’s financial statements are correctly drawn in accordance with the ordinary principles of commercial accounting and in conformity with the Ordinance, no further modifications are required or permitted. Where the taxpayer may draw up its financial statements on either of two alternative bases, the Commissioner is both entitled and bound to ascertain the assessable profits on whichever basis the taxpayer has chosen to adopt. He is bound to do so because he has no power to alter the basis on which the taxpayer has drawn its financial statements unless it is inconsistent with a provision of the Ordinance. But he is also entitled to do so, with the result that the taxpayer is effectively bound by its own choice, not because of any estoppel,

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but because it is the Commissioner's function to make the assessment and for the taxpayer to show that it is wrong.'

14. The evidence before us was unequivocal and clear. The Taxpayer's accounts were approved by its directors and certified by its auditors as having been prepared in accordance with the proper accounting principles generally accepted in Hong Kong. The Statement of Standard Accounting Practice ('SSAP 3') followed by SSAP 23 – Construction Contracts – issued by the Hong Kong Society of Accountants (now known as the Hong Kong Institute of Certified Public Accountants) provides the relevant accountancy policy that is to be followed. The relevant provisions in SSAPs 3 and 23 are as follows:

- ' 12. The amount at which long term contract work in progress is stated in periodic financial statements should be cost plus any attributable profit, less any foreseeable losses and progress payment received and receivable.'
- ' 9. Attributable profit is that part of the total profit currently estimated to arise over the duration of the contract (after allowing for likely increases in costs so far as not recoverable under the terms of the contract) which fairly reflects the profit attributable to that part of the work performed at the accounting date. (There can be no attributable profit until the outcome of the contract can be assessed with reasonable certainty.)'
- ' 45. ... Owing to the length of time taken to complete (long-term) contracts, to defer taking profit into account until completion may result in the profit and loss account reflecting not so much a fair view of the activity of the company during the year but rather the results relating to contracts which have been completed by the year end. It is therefore appropriate to take credit for ascertainable profit while the contracts are in progress ...'
- ' 21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognized as revenue and expenses respectively by reference to the stage of completion of the contract activity at the balance sheet date.'
- ' 24. The recognition of revenue and expenses by reference to the stage of completion of completion of a contract is often referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. This method provides useful information on the extent of contract activity and performance during period.'

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25. Under the percentage of completion method, contract revenue is recognized as revenue in the profit and loss account in the accounting periods in which the work is performed ...'

15. Therefore, in accordance with the GAAP, the Taxpayer recognized profit from incomplete long term contracts on the basis of the percentage of completion method. Company B gave a true and fair view of the Taxpayer's affairs at the balance sheet dates and in turn, these were properly prepared in accordance with the Companies Ordinance. It is of interest to note that for the year ending 1998, a profit available for distribution was HK\$7,254,007 and an interim dividend of HK\$3,400,000 was delivered. Indeed, the Taxpayer disclosed the accounting policy in its financial audited statements for the years ended 1997 and 1998 and stated as follows:

'Fee income is recognised when services are provided and is determined using the percentage of completion method in respect of long-term contracts.'

16. In respect of the accounts for the year ended 1999, that is, in respect of the year of assessment 1998/99, the accounts stipulated as follows:

'Fee income is recognized when services are provided in respect of construction contracts.

When the outcome of a construction contract can be estimated reliably, revenue from fixed price construction contracts is recognized on the percentage of completion method, measured by reference to the proportion that costs incurred to date bear to estimated total costs for each contract. Variations in contract work, claims and incentive payments are included to the extent that they have been agreed with the relevant customer.

When the outcome of a construction contract cannot be estimated reliably, contract revenue is recognized only to the extent of contract costs incurred that it is probable will be recoverable.'

17. There can be no doubt in our view and having regard to the cases that we have already cited, profits so computed by the Taxpayer must be subject to profits tax. Hence, by virtue of CIR v Secan Ltd & Another [2000] 3 HKCFAR 411, the Taxpayer is clearly bound by its accounting treatment and is not entitled to adjust or modify its assessable profits by way of a computational adjustment on the basis of the completed contract method. Again, we have no hesitation in accepting that the profits tax assessments in question are correctly raised in accordance with the Taxpayer's accounting treatment and GAAP.

18. However, the Taxpayer drew to our attention that they rely heavily on the relevant Departmental Interpretation and Practice Notes ('DIPNs'). However, it is quite clear that the

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information contained in the DIPNs are only for information and guidance of taxpayers and their authorized representatives. It has been made clear that these practice notes have no binding force and do not affect a person's right of objection or appeal. Indeed, we rely on D110/98, IRBRD, vol 13, 553 and more recently D54/06, (2006-07) IRBRD, vol 21, 1037 whereby it was stated as follows:

'... The Practice note issued by the Commissioner was issued for the guidance of taxpayers and their authorized representatives. It may represent the view of the Commissioner. But as is made clear in the Notes, it has no binding force of law. It does not bind the Board. The Board must approach each case by applying the law to the facts. It would not be right or necessary for the Board to consider whether the facts of a given case fall within certain paragraphs on the Notes; and certainly wrong for the Board to determine a case as if the Notes represents the law.'

19. The Taxpayer submitted that they were entitled to rely on two sets of accounts and took the view that the audited accounts prepared by Company B were subject to the tax computation which in their view could be put forward on a different basis. We reject this submission since it is not supported by any authority and is contrary to the authorities that we have already dealt with in this decision. Again, we remind ourselves that the burden of proof in respect of this matter is clearly established in section 68(4) of the IRO and the Taxpayer has the onus of proving that the assessment appealed against is excessive or incorrect. Again, we take the view that the Taxpayer has not discharged the burden of proof imposed by the IRO.

20. It is also quite clear that the relevant assessments are not excessive because in short, they were computed in accordance with the Taxpayer's own accounting treatment which accorded with GAAPs. We also take comfort from the fact that the relevant cases that we have already cited have clearly established that the taxation treatment should follow the accounting treatment unless this is in conflict with the IRO. The percentage of completion method adopted by the Taxpayer must be applied for taxation purposes. We also take the view that the Taxpayer's submissions that in the past, the IRD may have allowed various computations on a different basis in accordance with DIPNs are of little relevance or force. As we have previously indicated, these Practice Notes do not bind the Board.

21. The Taxpayer also put forward a submission that the Secan decision is not retrospective. Again, we have no hesitation in rejecting this particular submission. We rely on HKSAR v Hung Chan Wa & Another, CACC 411/2003. Stock JA stated as follows:

'14. In the interpretation of a statute, judges decide what the meaning of an enactment was at the date of its enactment and, by reason of the declaratory theory of judicial decisions, this applies even where there has been an earlier judgment that has provided a contrary interpretation

which the later decision overrules; for the effect of overruling is that the earlier decision did not represent the law ... the starting point is that:

“... the interpretation [of a statute] the court gives an Act of Parliament is the meaning which, in legal concept, the statute has borne from the very day it went on to the statute book.”

Conclusion

22. Therefore, having regard to our analysis of the evidence, the submissions put forward to us, we have no hesitation in coming to the conclusion that the relevant assessments in question are upheld and the Taxpayer's appeal is dismissed.