Case No. D58/96

Profits tax – deduction of financial cost under section 16(1) in assessing the assessable profit – whether interest payable has been deducted under section 16(1) of the Inland Revenue Ordinance.

Panel: Ronny Wong Fook Hum QC (chairman), Stephen Lau Man Lung and Peter F Rhodes.

Dates of hearing: 27, 28 June and 1 July 1996.
Date of decision: 25 October 1996.

The taxpayer is a company engaged in property development and investment. The issue is whether or not the interest payable by the taxpayer has already been deducted under section 16(1) of the Inland Revenue Ordinance. It is contended by the taxpayer that the interest had not been deducted in accordance with the statutory rule when it adopted the accounting treatment of capitalization of interest. It is, however contended by the Revenue that the taxpayer has already deducted the interest under section 16(1) in assessing its assessable profits.

Held:

1. In computing assessable profits, the starting point is not section 16 but section 14(1).

2. What has to be computed is the true profit and loss of the taxpayer. The ordinary commercial principles have to be taken into account in deciding how the profits are to be ascertained (CIR v Lo & Lo 2 HKTC 34, followed).

3. The practice of capitalization of interest by the taxpayer involves deducting of the whole of the interest incurred but the crediting against them of a closing figure for work in progress as a notional receipt. The interest in question was deducted under section 16(1) to compute the true profit of the taxpayer according to ordinary commercial principles.

Appeal dismissed.

[**Editor's note:** The taxpayer has filed an appeal against this decision.]

Cases referred to:

CIR v Mutual Investment Ltd [1967] 1 AC 587

Whimster v IRC 12 TC 813
CIR v Lo & Lo 2 HKTC 34
Duple Motor Bodies Ltd v Ostime 39 TC 537
Gallagher v Jones [1993] 537
Johnston v Britannia Airways [1994] STC 763

David Milne instructed by Legal Department for the Commissioner of Inland Revenue.
John Gardiner instructed by Woo, Kwan, Lee & Lo for the taxpayer.

Decision:

I. THE AGREED FACTS:

1. The Company was incorporated on 20 November 1987 under the Hong Kong Companies Ordinance. At all relevant times, the Company was and is ultimately beneficially owned by the following companies:

	% of shareholding
Company A	50
Company B	30
Company C	20
	100
	===

At all relevant times, the nature of the Company's business, as described in its Report of Directors attached to its accounts, was 'property development and investment'. A copy of the Director's Report and the accounts for the period 20 November 1987 to 31 December 1988, and the years ended 31 December 1989, 1990 and 1991 were presented to the Board.

2. By and agreement dated 28 January 1988, the Company acquired an interest in a substantial piece of land at District D for the purposes of redevelopment. The Company's intention in respect of the redevelopment was recorded in resolutions of its directors dated 28 January 1988.

3. The development carried out on the land was of a large housing and commercial complex known as 'Estate E' which was completed by phases. Although the Company's board resolution of 28 January 1988 referred to both development for resale of residential units and development for rental of commercial portions for long term investment, the latter only comprised a very small proportion of the overall development and in the event the only parts retained by the Company were the residential car parking and

some commercial portions. The commercial area and one of those portions were respectively sold and treated as sold in 1992, the proceeds of sale being brought into account for profits tax purposes.

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

5. In consequence of the terms of the agreement dated 28 January 1988 the Company was obliged to incur expenditure of $2,343,483,688 for the acquisition of its land at District D. This was made up of payments as follows:

	$
Company F	846,032,282
Company G	293,260,334
Company H	144,603,141
Company I	360,000,000
Company J	623,300,000
	2,267,195,757
Stamp duty and professional charges	76,287,931
Total acquisition cost	2,343,483,688

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

(a) Bank Loans

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

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

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

(b) Shareholders/related companies loans

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

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

		$
Period 20 November 1987 to 31 December 1988		130,607,084
Year to 31 December 1989		250,484,062
Year to 31 December 1990		274,725,465
Year to 31 December 1991		209,832,059
	Total	865,648,670

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

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

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

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

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

	31-12-1988	**31-12-1989**	**31-12-1990**
	$	**$**	**$**

Assets			
Property under development	2,408,540,480	2,776,640,404	3,480,840,161
Liabilities			
Long term bank loan	1,600,000,000	1,600,000,000	2,600,000,000
Due to related companies	640,000,000	895,969,498	708,228,720
Due to ultimate shareholder	160,000,000	223,992,374	-

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

	31-12-1988 **$**	**31-12-1989** **$**	**31-12-1990** **$**
Bank loan interest	25,622,267	186,896,923	380,706,509
Other loan interest	104,984,817	194,194,223	275,110,102
Financing charges	-	-	7,102,117
	130,607,084	381,091,146	662,918,728

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

'Loss for the period is arrived at after charging:

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

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

'Loss before taxation is arrived at after charging

	$
Auditors' remuneration	16,000
Directors' remuneration	
- fees	-
- other emoluments	-
Interest on bank loan, overdraft and other loans wholly repayable within five years	250,484,062
Less: Amount capitalised to property under development	(250,484,062)'

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

'Profit before taxation is arrived at after charging

Interest on bank loan, overdraft and other loans wholly repayable within five years	$274,725,465
Less: Amount capitalised to property under development	($274,725,465)
Auditors' remuneration	$18,000
Directors' remuneration	
- fee	-
- others	-'

12. The profit/losses before taxation referred to above are derived from the detailed profit and loss accounts submitted with the tax computations. The detailed profit and loss accounts for the period to 31 December 1988 and the years to 31 December 1989 and 1990 were presented to the Board. No amounts were included within those detailed profit and loss accounts for those years in respect of or representing the 'Property under development' or the cost thereof.

13. For the years of assessment 1988/89 and 1989/90 the Company, in its tax computations, showed losses of $26,300 and $20,270. For the year of assessment 1990/91 the Company, in its tax computation, showed assessable profits of $505,994 after setting-off of the losses brought forward. The receipts giving rise to this assessable profit (after the deduction of expenditure and losses) were derived mainly from interest receivable on

purchasers' deposits on forward sales of uncompleted units and transfer fees in the development. These losses and profits for the respective years were agreed by the assessor.

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

Properties under development		$4,264,891,160
Fixed assets	$18,670,017	
Less: depreciation	$ 43,014	$18,627,003
Properties for sale		$6,726,111

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

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

Profit from sales of flats $910,358,773

The above amount being computed as follows:

Proceeds of sale		$1,802,948,787
Less		
Costs of sales, being		
Land and development cost	$802,962,340	

Financing cost	$ 63,205,546	$866,167,886
Selling expense		$ 26,422,128
		$892,590,014
	Profit	$910,358,773

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

16. The total cost of sales of $892,590,014 referred to in paragraph 15 above, taken into account in computing profit in the profit and loss account included a part of the total financing cost equal to $63,205,546. Consequently that amount was taken into account as a deduction in computing the profits recognised in the profit and loss account for the year to 31 December 1991. The cost of sales (including the amount of interest and loan arranging fees of $63,205,546 but excluding selling expense of $26,422,128) was $866,167,886. This amount had been deducted from the cumulative figure of cost for the properties under development of $5,156,455,174. That figure, together with the figures of $18,670,017 (fixed assets) and $6,726,111 (properties for sale) referred to in paragraph 14 above had been transferred out of the total figure of $5,156,455,174 in respect of properties under development. In consequence the latter (that is, properties under development) as at 31 December 1991 stood at a figure of $4,264,891,160. Split between land and development and financing costs that figure (as at 31 December 1991) was made up as follows:

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

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

	$
Period to 31 December 1988	130,607,084
Year to 31 December 1989	250,484,062
Year to 31 December 1990	281,827,582

Year to 31 December 1991		210,750,568
	Total	873,669,296
		=========

17. Prior to submitting its tax computation for the year of assessment 1991/92 the Company had made no claim for the deduction of interest whatever; not had any amount of interest been deducted in computing the profit appearing in its profit and loss account.

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

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

20. In its 1991/92 tax computation the Company claimed as a deduction financing expenses incurred by it to 31 December 1991 of $810,463,750. This amount together with the figure of $63,205,546 already deducted represented the total amount of interest and financing costs paid for the purposes of the development as set out in paragraph 6 above. This represented a claim for the then current year and a carry forward of the losses represented by such interest payments in the previous years.

21. The assessor did not accept the profits as returned by the Company and on 19 October 1992 raised on it the following assessment:

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

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

22. On behalf of the Company, the Representatives for the Taxpayer (the Representatives) then objected against the assessment as set out in paragraph 21 on the ground that:

> '… interest paid on loans financing the development of the Company's properties should be deducted from the assessable profits under section 16(1) and section 16(1)(a).'

23. By letter dated 11 November 1992 the assessor requested further information from the Company as to the interest expenses concerned. By letter dated 9 December 1992, the Company replied via its Representatives. By letter dated 23 June 1993, the assessor requested further information as to the interest expenses concerned; the Company replied by letters dated 21 July 1993 and 16 August 1993.

24. By letter dated 7 January 1994 the Commissioner rejected the said objection and determined the assessment for the year of assessment 1991/92 dated 19 October 1992 showing net assessable profits of $1,063,344,435 with tax payable thereon of $175,451,831.

25. By letter dated 4 February 1994 the Company gave notice of appeal against the assessment.

26. An analysis of the items appearing in the profit and loss accounts and balance sheets and a reconciliation of interest claimed and charged for all periods was presented to the Board at the hearing.

27. In relation to the objection it is agreed between the parties that:

(a) if section 16(2) applies, either condition (c) or (d) is satisfied;

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

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

II. THE AGREED ISSUES

1. The 2 issues agreed between the parties are:

(a) First Issue: whether or not the interest payable by the Taxpayer, the Company, in each of the basis periods, 20 November 1987 to 31 December 1988, 1 January 1989 to 31 December 1989 and 1 January 1990 to 31 December 1990, has already been deducted under section 16(1) of the Inland Revenue Ordinance (the IRO) in the computation of assessable profits or adjusted losses shown on the tax returns originally submitted by the Taxpayer for the years of assessment 1988/89, 1989/90 and 1990/91.

(b) Second Issue: if so, whether the Taxpayer is entitled to re-open the accounts for those years.

2. In relation to the First Issue: the Taxpayer says that the interest payable has not been so deducted.

3. In relation to the Second Issue: Whilst this is part of the agreed issues, the arguments on behalf of the Taxpayer, resting in essence on section 16 of the IRO, supports the Revenue's contention that 'the Taxpayer has eschewed this argument in any event'.

III. ACCOUNTANCY EVIDENCE FOR THE TAXPAYER

1. Mr M

(a) Mr M is a partner of an accounting firm. He has worked in Hong Kong since 1975. He is a fellow of the Hong Kong Society of Accountants ('HKSA').

(b) He has not signed any audit reports of property companies in recent years.

(c) Mr M explains that accountants preparing accounts in Hong Kong are guided by Statements of Standard Accounting Practice ('Accounting Standards') and Accounting Guidelines ('Accounting Guidelines') set out in Volume II of the HKSA Members' Handbook. According to the Forward to those Accounting Standards and Accounting Guidelines, they differ in their authority. In the Forward in issue until December 1991, Accounting Standards were stated to contain methods of accounting approved by the Council of the Hong Kong Society of Accountants for application to all financial statements intended to give a true and fair view. Accounting Guidelines were to have effect as 'guidance statements and indicators of best practice'. They are persuasive in intent and departures from them do not necessarily require disclosure from accounting standards.

(d) With respect to the treatment of interest, there are no applicable Accounting Standards in Hong Kong and there were none during that accounting periods in question. Statement 2.205 'Accounting Guideline – capitalization of borrowing costs' ('Guideline 2.205') was issued in October 1985 and is specifically relevant to the accounting treatment adopted by the Taxpayer.

(e) Guideline 2.205 recommends the capitalization of borrowing costs as part of the cost of an asset which requires a substantial period of time for its use or for sale. However, paragraph 4 of Statement 2.205 states that such treatment is not mandatory. It is therefore acceptable for any entity preparing accounts under accounting principles generally accepted in Hong Kong to expense borrowing costs as and when incurred, provided such a policy is adopted consistently. Expensing borrowing cost is consistent with the view that such costs are essentially period costs which should be charged to income regardless of how

the borrowing is applied. Capitalising borrowing costs is consistent with the view that in certain specific instances, the costs form part of the asset with which they can be identified and accordingly should be capitalised.

(f) In April 1995 the HKSA issued for comment an exposure draft of a proposed accounting standard on borrowing costs. The exposure draft proposes that borrowing costs which are directly related to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. This exposure draft reflects an alteration in the views of the HKSA and a departure from the principles set out in IAS 23 and IAS (revised 1993) which recommend as its 'benchmark' treatment that interest should be expensed through the profit and loss account. This exposure draft became SSAP 19 in May 1996. The existence of this exposure draft or SSAP19 does not alter Mr M's view that during the accounting periods in question, it was and is acceptable for any entity preparing accounts under accounting principles generally accepted in Hong Kong to expense borrowing costs as and when incurred, provided such a policy is adopted consistently.

(g) Mr M was cross examined on paragraph 11 of Guideline 2.205. He explained that paragraph 11 is based on the fundamental concept that the guidelines should be applied consistently. Paragraph 11 says that if one embarks on a route of capitalising interest one should continue to capitalise interest. When this might result in an aggregate cost being greater than the realisable value of the development project, the prudence concept would require making provision for future losses. He accepts that such exercise is attributable to the basic accounting principle that in valuing work in progress at the end of the year one takes the cost or market value, whichever is the lower. The adjustment would have to be made in the balance sheet and the profit and loss account.

(h) In relation to the Taxpayer, it is his view that there should be capitalization in accordance with the best practice guideline although it would be possible, as a matter of accounting theory, to have prepared accounts of the Taxpayer by expensing interest. Had such treatment been adopted, had he been the auditor, he would have had to allow the Taxpayer to do it. It would have been a material accounting policy and it would therefore have to be clearly explained. It would have been unusual because most companies in Hong Kong prefer to show profits rather than losses so they would prefer to defer taking the interest expense.

2. Mr N

(a) Mr N is the senior partner in Company O. Company O has more than 10,000 audit and tax clients. A great portion of those clients are listed property companies or are manufacturing concerns. Through his involvement with those clients, he has ample knowledge and experience as to how trading stock

and interest are dealt with in the accounts and tax computation of companies in Hong Kong.

(b) He was the partner in charge of Company O's services to Company B and its subsidiaries ('the B Group') and that of the Taxpayer. The principal business of the Taxpayer has been the development of properties for sale. Accordingly all the properties held by the Taxpayer (with the exception of a minor portion to be retained as investments), whether completed or under development, should be regarded as the trading stock of the Taxpayer.

(c) With respect to the treatment of interest, there are no applicable accounting standards or guideline in Hong Kong prior to 1985. It was not until October 1985, that Guideline 2.205 was released by the HKSA. Guideline 2.205 adverted to 2 views in the accounting profession as to the treatment of interest on funds borrowed to acquire certain assets. Ultimately, guideline 2.205 recommends the capitalization of borrowing costs, but does not make capitalization mandatory. Had the Taxpayer chosen to deduct interest in its profit and loss account (taking no contra credit by way of capitalization) in the year such expenditure is incurred, Company O would have given an unqualified audit report in relation to the accounts.

(d) He does not accept that it is his professional judgment in each case as to which method is right for the company in question. He maintains that it is for the directors of that company to decide which of the two accounting policies that it should adopt: it could either capitalise the financing charges or simply charge them to the profit and loss account in the year incurred. If a major property developer decides to expense interest payments, as auditors, Company O would point out the alternative of capitalization but if the directors maintain their decision to expense interests, the auditors could not object or qualify their audit report. On the other hand, if the directors decides to capitalise interest, Company O would only suggest expensing if there is a reason to put forward such suggestion.

(e) The Taxpayer, on its own accord, had chosen to adopt the policy of capitalising interest. This is the method generally adopted by the listed property companies that are clients of Company O. Concerns about results and dividend covers led to the adoption of this method by those listed property companies. Private companies, on the other hand, are less concerned about shareholders and the press but more concerned in securing the tax benefit in year on which leads to their rejection of the capitalization method.

(f) He does not agree with the suggestion that if the expensing method be adopted for the Taxpayer, substantial losses would appear in the first two years when there were no sales and the accounts of those years would have been so misleading as to no longer render them true and fair.

(g) He is of the view that interest payable by the Taxpayer prior to the year of assessment 1991/92 was not deducted in computed profits in its profit and loss account. Prior to any sale such interest is reflected in the item 'Property under development' in the balance sheet. The net result is that there was no interest being charged in the profit and loss account.

IV. OTHER EVIDENCE FOR THE TAXPAYER

1. Mr P

(a) He is the Group Managing Director of Company A. He joined Company B, a substantial shareholder in Company A, in 1979 and became Deputy Managing Director in 1987. During his 14 years with Company B, he was responsible for the overall corporate finance and investment of the group. He is also a director of the Taxpayer throughout all periods in which it has been conducting business.

(b) Mr P is a member of a professional institute of Chartered Accountants. He was aware that it was open to the Taxpayer either to capitalise the interest payments or simply to charge them to its profit and loss account.

(c) A policy of capitalization had generally been adopted within the B and A groups since it avoided showing substantial losses in the early years of development unmatched by any receipts.

(d) The subject matter of the current dispute is the result of legal advice given to the Taxpayer who was not previously alert to the point.

V. ACCOUNTANCY EVIDENCE FOR THE REVENUE

1. Mr Q

(a) Mr Q qualified as a Chartered Accountant in 1975. He joined Company R and was admitted into partnership in 1985. He provided auditing and consulting services to Hong Kong companies involved in manufacturing, printing, public relations, advertising, restaurants, real estate development, construction and hospitality services. He is also familiar with China listings, China tax and audit matters. However at no time did he have audit responsibility over large publicly quoted property development companies in Hong Kong. His firm has no such client as at the date of hearing.

(b) He pointed out that for the years in question, there was no HKSA accounting standard which dealt with borrowing costs. He made reference to Guideline 2.205 and IAS 23 and said 'both (almost identically) address the issue at hand'. He cannot recall whether there is any substantial difference between the 1993

revised IAS 23 (which recommends expensing) and its predecessor (which recommends capitalization).

(c) He adverted to paragraph 7 of Guideline 2.205 which provides that:

'Capitalization of borrowing costs should commence when:

(a) expenditures for the asset have been made;

(b) activities which are necessary to prepare the asset for its use or sale are in progress;

(c) borrowing costs are being incurred'

He concluded that 'Given that all three of the Guideline's criteria for capitalising borrowing costs were met by the Company, its borrowing costs should have been capitalised.' It is clear from cross examination that he has erroneously elevated the 'Recommended Accounting Practice' in the event of capitalization as if the same were 'criteria' for determining whether there should be capitalization.

(d) He drew attention to 2 fundamental accounting concepts in HKSA Statement 2.101: 'Statement of Standard Accounting Practice – Disclosure of Accounting Policies':

(i) The 'Accruals' Concept: 'Revenue and costs are accrued (that is recognized as they are earned or incurred, not as money is received or paid), matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the profit and loss account of the period to which they relate; provided that where the accruals concept is inconsistent with the "prudence" concept, the latter prevails'.

(ii) 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…'

(e) He is of the view that all costs incurred prior to, and necessary for development should therefore be matched against the proceeds generated from the property after resale. As financing costs were part of the necessary costs, they should be included in the costs prior to, and necessary for, development. This necessitates the capitalization of these costs until development has been completed in order to properly match the expense with the revenues generated as a result of the development. He is of the further view that the financing costs were not in the nature of losses but comprised part of the anticipated

redevelopment cost at the date of acquisition. Losses would only have arisen if circumstances had changed from the date of acquisition such that market value or proceeds anticipated after the development, were expected to be less than all costs (including interest costs) required to acquire and develop the property. If such potential losses were identified in the years ended 1988 through 1991, then a provision against the entire carrying cost of the property, not just the borrowing cost element, should have been recorded and expensed to the profit and loss account.

(f) He also explained why, as a matter of basic accounting principle, it is necessary to place a value on trading stock at the close of an accounting period, and why conversely the cost of trading stock should not be charged to profit and loss wholly in the year in which it was purchased or produced. He is of the view that the Taxpayer's stock in trade requires a period of several years to complete, and therefore matching of revenues with expenses is not achieved if interest is expensed as incurred.

(g) He says if interest expense of the Taxpayer had been expensed each year in the audited accounts as incurred rather than having been capitalized, the accounts of the Taxpayer would have appeared as follows:

	20-11-1987 to 31-12-1988 $	**Year ended 31-12-1989 $**	**Year ended 31-12-1990 $**	**Year ended 31-12-1991 $**
Turnover	1,000	1,000	572,229	1,958,941,091
Income (Loss) before Taxation per Accounts	(31,000)	(20,270)	552,564	1,066,230,873
Interest Expense Accrued	(130,607,084)	(250,484,062)	(274,725,465)	(209,832,059)
Financing Costs Capitalized	0	0	(7,102,117)	(918,509)
Less: Interest expense included in Cost of Sale	0	0	0	63,205,546
Adjusted Net Income (Loss) Before Tax	(130,638,384)	(250,504,332)	(281,275,018)	918,685,851

(h) He pointed out that the expensing of the interest to the profit and loss account represents this as an economic transaction resulting in losses to the Taxpayer in the years ended 31 December 1988, 1989 and 1990 which clearly was not the case. The financing costs were, in substance, expenses incurred in order to make the asset ready for resale. They should add value to the asset and not result in loss to the company. He considers that it is the duty of the auditor to consider what is the appropriate method for a particular company. He would

have qualified the financial statements as not representing a true and fair view if the directors insist in so expensing the finance charges of the company.

(i) His review of the annual reports of 12 listed property developers in Hong Kong indicates that all of them capitalised interest expense associated with property development activities.

VI. THE RELEVANT STATUTORY PROVISIONS IN THE INLAND REVENUE ORDINANCE

1. By section 14, profits tax is charged in each year of assessment 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 for that year from such trade, profession or business (excluding profits arising from the sale of capital assets)…'

2. By section 15 a number of items are deemed to be trading receipts for the purposes of section 14.

3. Section 16 provides for certain deductions to be made in ascertaining profits. It provides as follows:

'In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period including –

(a) ... sums payable by such person by way of interest upon any money borrowed by him for the purpose of producing such profit…'

4. 'Assessable profits' are defined in section 2 to mean:

'the profits in respect of which a person is chargeable to tax for the basis period for any year of assessment, calculated in accordance with the provisions of Part IV.'

VII. SUBMISSIONS OF THE TAXPAYER

1. The amount of $810,463,750 was interest payable in the period to 31 December 1988 and the years to 31 December 1989, 1990 and 1991.

2. Section 16 of the IRO prescribes a statutory code for the ascertainment of profit and specifically, where interest is concerned, it provides a statutory rule whereby interest

shall be deducted in the basis period in which it was payable. On the basis of CIR v Mutual Investment Ltd [1967] 1 AC 587, principles of accounting cannot displace the rules of tax law as laid down by the IRO.

3. This rule must be applied simply by force of the statute and it is irrelevant if the taxpayer's accounting treatment has taken the deduction in some other year or never taken a deduction at all.

4. Principles of accounting does not dictate capitalization of interest. An auditor would not, and could not, qualify an audit report solely by virtue of the adoption by the Taxpayer of the method of expensing interest.

5. In adopting the accounting treatment of capitalization of interest, the interest and loan fees in question had not been deducted in accordance with the statutory rule. The assessable profits under section 14 were not reduced or the losses to be carried forward under section 19(c)(4) were not increased in the relevant basis periods.

VIII. SUBMISSIONS OF THE REVENUE

1. The Taxpayer has had the interest deducted already under section 16(1) in ascertaining the 'assessable profit' or 'adjusted loss' for the purpose of section 14. The interest was deducted, together with all the other revenue expenses incurred during the same year (such as auditor's remuneration) in computing the assessable profit (or adjusted loss).

2. The starting point is not section 16 but section 14(1). In computing profits for the purposes of section 14, expenditure on stock and work-in-progress which is unsold at the end of the year must be brought into the profit computation on some basis of valuation, for example, 'cost or market value, whichever is the lower' Whimster v IRC 12 TC 813.

3. As indicated by the first instance judgment of Hunter J in CIR v Lo & Lo 2 HKTC 34 at 54, the Hong Kong system is most analogous in substance to the United Kingdom system:

(a) It is necessary to compute the profits or gains of the taxpayer in the year in question.

(b) To enable the true profit to be determined it is necessary to deduct from receipts any sum which is an essential charge against those receipts.

(c) In deciding how the profits are to be ascertained the Courts have regard to ordinary commercial principles.

4. On the basis of Duple Motor Bodies Ltd v Ostime 39 TC 537 and Gallagher v Jones [1993] STC 537

(a) The question is *'not what expenditure it is proper to leave in the account as attributable to goods sold during the year, but what expenditure it is proper, in effect, to exclude from the account by setting against it a figure representing stock-in-trade and work in progress' [per Lord Reid in Duple Motor Bodies at page 571]. This involves 'the deduction of the whole of the expenses incurred during the period but the crediting against them of a closing figure for unsold stock and for work in progress as a notional receipt'* [Per Lord Nolan in Gallagher v Jones [1994] chapter 107 at page 136 C-D]

(b) The real question is, what method best fits the circumstances of a particular business. And if a method has been applied consistently in the past, then it should not be changed unless there is good reason for the change sufficient to outweigh any difficulties in the transitional year [per Lord Reid in Duple Motor Bodies at page 572].

5. The Taxpayer's submissions confuse accounting principle with accounts presentation. As Lord Nolan explained in Gallagher v Jones, the expenses (including interest) have been deducted in full in computing the assessable profits, but they do not show because there is credited against them a closing figure for Work-In-Progress as a closing receipt.

6. CIR v Mutual Investment is simply a case on the meaning of the words 'in the production of assessable profit' in section 16(1). That case says that you must start with the 'Assessable profits' under the IRO to make your deductions; you do not start with all business receipts.

7. The evidence of the experts is of limited relevance as the Taxpayer's case is based solely on section 16(1) and CIR v Mutual Investment Ltd.

8. On the assumption that the Commissioner's submissions outlined above are accepted by this Board, the Taxpayer is not entitled, on the authority of Johnston v Britannia Airways [1994] STC 763 to change its basis for valuing work in progress from capitalising to expensing interest. The question is what method of valuation is the most appropriate for the Taxpayer according to generally accepted accounting principles and the expert evidence indicates that capitalizing was the better accounting treatment.

IX. ADDITIONAL FINDINGS OF FACT

1. We refer to paragraph 17 of the Agreed Statement of Fact.

2. As accepted by Mr N, we further find that paragraph 17 should read:

'Prior to submitting its tax computation for the year of assessment 1991/92 the Company had made no claim for the deduction of interest whatever; nor had any amount of interest been deducted (other than that matched by an equivalent

contra entry for interest capitalised) in computing the profit appearing in its profit and loss account'.

X. OUR VIEWS ON THE ACCOUNTANCY EVIDENCE

1. Mr Q has no experience in auditing accounts of publicly listed property companies in Hong Kong. He also has little involvement in drafting the relevant Standards and Guidelines of the HKSA. His erroneous characterisation of paragraph 7 of Guideline 2.205 and his failure to identify the material differences between the 2 versions of IAS 23 cast serious doubts on the veracity of his evidence. Given the arguments set out in Part 1 of Guideline 2.205 in support of the two then current schools of thought, we do not accept his evidence that adoption by the Taxpayer of the expensing method calls for qualification of its account.

2. We find that at the material period:

(a) the prevalent if not the universal practice of publicly listed property companies in Hong Kong was to capitalise interest. This is because this method produces results which accord with their commercial objectives.

(b) the applicable accountancy guideline and principles do not provide a bar to adoption by these companies of the method of expensing interest when they prepare their accounts. Adoption of such method is a material accounting policy which would have to be clearly explained.

XI. OUR DECISION

1. At the conclusion of arguments, if is clear that the accountancy evidence has only limited relevance to the first issue agreed between the parties. It is common ground that the Taxpayer had adopted the accounting treatment of capitalization of interest. The issue is whether the interest in question has already been deducted for the purpose of section 16 in the process of capitalization.

2. We reject the submissions of the Taxpayer that the IRO lays down a statutory code for the ascertainment of assessable profit. We accept the Revenue's contentions that the first instance judgment of Hunter J in <u>Lo & Lo</u> makes it clear that our system is analogous to the UK system. It is necessary to compute the true profits or gains of the taxpayer in the year in question and to have regard to ordinary commercial principles in deciding how the profits are to be ascertained.

3. The accounts of the Taxpayer in capitalising interest were approved by its directors. Its auditors were of the view that those accounts 'give a true and fair view' of the state of the Taxpayer's affairs for the relevant periods. Retrospectively expensing interest and producing thereby for the first time substantial losses for the periods in question calls for explanation from its directors to justify how such treatment can be said to present a fair and true view of the company's affairs in the light of their previous approvals. Given his

awareness of the options in either capitalising or expensing interest, we are not persuaded by the evidence or Mr P that such retrospective treatment accords with what the directors of the Taxpayer regarded at the material times as the fair and true view of the Taxpayer's affairs.

4. As explained by Lord Nolan in Gallagher v Jones, as a matter of legal analysis, the practice adopted by the Taxpayer in capitalising interest involves the deduction of the whole of the interest incurred during the period but the crediting against them of a closing figure for unsold stock and for work in progress as a notional receipt. This analysis makes it clear that the interest in question was deducted for the purpose of section 16(1) in computing the true profit of the Taxpayer in accordance with ordinary commercial principles.

5. For these reasons we would answer the 2 agreed issues as follows:

(a) First agreed issue: Yes. Already deducted.

(b) Second agreed issue: Not entitled.

We would like to thank all Counsel for their valuable assistance in this matter.