

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D71/90

Profits tax – change of accounting date – basis period to be used – principles to be applied – section 18E of the Inland Revenue Ordinance.

Panel: Denis Chang QC (chairman), Robert G Kotewall and Eric Lo King Chiu.

Dates of hearing: 12 and 13 February 1990.

Date of decision: 27 February 1991.

The taxpayer commenced business in Hong Kong in 1963. Its accounts for each year were made up to 28 February until 1986 when it changed its accounting date to 30 September. This brought into play section 18E of the Inland Revenue Ordinance under which the Commissioner was empowered to compute the assessable profits for the year of assessment in which the change incurred 'on such basis as the Commissioner thinks fit'. The taxpayer submitted audited accounts for the period 1 March 1986 to 30 September 1986 and proposed in its tax computation that a seven months basis period be adopted for the year of assessment 1986/87. The Commissioner adopted a different basis namely the twelve months period ended 30 September 1986 plus five-twelfth of the profits of the taxpayer for the year ended 28 February 1986. The Commissioner stated that in exercising his discretion he sought to adopt a basis period which would be both reasonable and expedient having regard to the trend of profits of the business, the desirability of maintaining the normal twelve months basis period for the year of assessment and to effect equity between the taxpayer and the Revenue. The taxpayer objected to the decision of the Commissioner.

Held:

A distinction must be drawn between old established businesses and those which commenced on or after 1 April 1974. In the present case the Commissioner had acted reasonably and within the powers given to him by the Inland Revenue Ordinance.

Appeal dismissed.

Cases referred to:

Commissioners of Inland Revenue v Helical Bar Ltd [1972] 48 TC 221

Sharp v Wakefield [1891] 1 AC 73

The Metropolitan Gas Co v Federal Commissioner of Taxation [1949] 9 ATD 5

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S McGrath for the Commissioner of Inland Revenue.
David Smith of Peat Marwick for the taxpayer.

Decision:

The Taxpayer was incorporated and commenced business in Hong Kong in 1963. Its accounts for each year were made up to 28 February until 1986 when it changed its accounting date to 30 September. This brought into play section 18E of the Inland Revenue Ordinance under which the Commissioner was empowered to compute the assessable profits for the year of assessment in which the change occurred (and for the year preceding that year of assessment) 'on such basis as the Commissioner thinks fit'.

The Taxpayer submitted to the Revenue a set of its audited accounts for the period 1 March 1986 to 30 September 1986 and proposed in its tax computation that a seven months basis period (that is, from 1 March 1986 to 30 September 1986) be adopted for the year of assessment 1986/87.

The Commissioner, however, adopted the following basis of assessment:

Basis period for the year of assessment

1 October 1985 to 30 September 1986	\$
Adjusted profits for return	1,257,221
<u>Add:</u> Adjusted profits per accounts for the year ended 28 February 1986 \$3,102,023 x 5/12	<u>1,292,509</u>
	\$2,549,730
<u>Less:</u> Depreciation and rebuilding allowances	<u>27,270</u>
Assessable profits	\$2,522,460 =====
Tax payable thereon	\$466,655 =====

The basis adopted by the Commissioner has therefore resulted in an 'overlap' of five months and hence the double use of profits (referrable to 5/12 of the profits per the

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Taxpayer's accounts for the year ended 28 February 1986). The Taxpayer complains that it has been unfairly assessed twice on the same profits.

The Commissioner in his written determination says that in exercising his discretion under section 18E it is his invariable practice to endeavour to achieve the following objectives:

- (i) To adopt a basis period using the new accounting date as the last date of the basis period as soon as reasonable and expedient, having regard to:
 - (a) the trend of profits of the business, so far as it is possible to discern a trend,
 - (b) the desirability of maintaining the normal twelve months basis period for the year of assessment, unless exceptional circumstances dictate;
- (ii) To effect equity; that is to say, that as regards the phrase 'on such basis as the Commissioner thinks fit' as placing upon him a duty to produce a result which will not unduly prejudice either the taxpayer or the Revenue.

The Commissioner in his written determination concluded that the basis period adopted by the assessor in the 1986/87 assessment was fair and reasonable and in accordance with the objectives referred to above; that in reaching his conclusion he has had regard to the trend of the Taxpayer's profits for the periods concerned and to the fact that the profits tax on the Taxpayer's profits for a period of five months would have been deferred; 'furthermore, it is desirable to adopt 30 September as the Taxpayer's accounting date at the earliest opportunity because in future the Taxpayer will make up its accounts annually to that date'.

It is necessary to look more closely at section 18E which says as follows:

- '(1) Where the assessable profits of a person from any trade, profession or business carried on in Hong Kong have been computed by reference to an account made up to a certain day in any year of assessment and either –
 - (a) that person fails to make up an account to the corresponding day in the following year of assessment; or
 - (b) that person makes up accounts to more than one day in the following year of assessment, then -
 - (i) the assessable profits from that source for the year of assessment in which the circumstances described in either paragraph (a) or (b) prevail shall be computed on such basis as the Commissioner thinks fit; and

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- (ii) the assessable profits for the year preceding that year of assessment shall be recomputed on such basis as the Commissioner thinks fit.
- (2) For the purposes of sub-section (1) -
 - (a) where the accounts of any trade, profession or business are made up to the end of the lunar year, the Commissioner may accept those accounts as being made up to a corresponding day in each year of assessment; and
 - (b) in the case of a trade, profession or business which was commenced on or after 1 April 1974, the Commissioner may, if he considers it necessary, make a computation under sub-section (1) in respect of a basis period which exceeds twelve months.
- (3) For the purposes of this part, where in the case of a trade, profession or business it is necessary in order to arrive at the assessable profits or the losses for any year of assessment to divide or apportion to specific periods the profits and losses for any period for which accounts have been made up, or to aggregate any such profits or losses or any apportioned parts thereof, it shall be lawful to make such division and apportionment or aggregation, and any such apportionment shall be made in proportion to the number of days or months in the respective periods unless the Commissioner, having regard to any special circumstances, otherwise directs.
- (4) ...'

It is to be observed that the present case falls into 18E(1)(a) – the Taxpayer failed ‘to make up an account to the corresponding day in the following year of assessment’. Had there been no change of accounting date from 28 February to 30 September the basis period for the year of assessment 1986/87 would be 1 March 1986 to 28 February 1987; the Taxpayer by changing its accounting date and making up its accounts upon a seven months basis period (from 1 March 1986 to 30 September 1986 as aforesaid) was failing ‘to make up an account to the corresponding day in the following year of assessment’.

It is also to be observed that when the Commissioner included in the assessment 5/12 of the profits per accounts for the year ended 28 February 1986 he was apparently exercising a power under section 18E(3).

To understand the legislative scheme, and the significance of the fact that the Taxpayer is a so-called ‘old established business’ (that is, commenced prior to 1 April 1974)

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it is necessary to look at the history of the relevant statutory provisions affecting the basis of computation of profits.

For the years of assessment up to and including the year of assessment 1974/75 (but subject to the provisions in the new sections 18A and 18C in respect of the computation of profits for the year of assessment 1974/75) the basis of assessment laid down in section 18 was the 'preceding year basis'.

Then with effect from the year of assessment 1974/75 onwards the basis of assessment was changed to that of the new 'current year basis' (section 18B). If accounts are consistently made up to 31 March the assessable profits for the continuing business will be the actual profit for the year of assessment (that is, for the year to 31 March): section 18B(1). If, however, accounts are consistently made up to a day other than 31 March, section 18B(2) gives authority for the profits for the year ending on the accounting date to be treated as the assessable profits for the year of assessment. Thus continuity is preserved in the case of existing businesses which have been assessed on the preceding year basis: the accounting year is retained to give the measure of profits for a year of assessment.

In the explanatory notes to the Inland Revenue (Amendment) Ordinance 1975, the Inland Revenue Department gives examples showing its understanding of how the new sections will operate and in the context of section 18E distinguishes between 'old established businesses' and those which commenced on or after 1 April 1974.

There is, we think, justification for the distinction. To begin with the change in the basis of assessment from the preceding year to the new basis means that the profits for one year of account of a business established before 1 April 1973 and which makes up annual accounts will not come into assessment at all.

In the case of a business which started after 1 April 1974, however, the profits will be wholly assessed on the new basis so that for a business for which accounts are consistently made up to the same day in each year 'assessments will equal in total the profits earned during the life of the business' (in the words of the explanatory notes).

Where, therefore, a new business changes its accounting date, other things being equal, it will be perfectly reasonable for the Commissioner, in the words of the explanatory notes (emphasis supplied) 'to make assessments on a basis which will ensure that profits not less than the total profits made over the life of the business are assessed and that in any year of assessment, other than the years of commencement and cessation (for which the provisions of sections 18C and 18D apply) the profits are not less than profits of a twelve months trading period'.

The Taxpayer has argued that the principle of taxing total profits made over the life of the business applies equally to businesses established prior to 1 April 1974 and that for this (and other reasons) the Commissioner has erred in the exercise of his discretion by not applying the principle to the Taxpayer's case.

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We are, however, of the view that the Ordinance itself recognises, for the purpose of section 18E, that an old established business stands on a different footing from a post 1 April 1974 business. Section 18E(2) stipulates that for the purposes of sub-section (1) – ‘in the case of a trade, profession or business which was commenced on or after 1 April 1974, the Commissioner may, if he considers it necessary, make a computation under sub-section (1) in respect of a basis period which exceeds twelve months’.

We think contrary to the Taxpayer’s submission that the Revenue is right in saying that for a business which commenced prior to 1 April 1974 the Commissioner may not make a computation under sub-section (1) in respect of a basis period which exceeds twelve months.

The Commissioner is given a discretion to adopt a basis period exceeding twelve months only in respect of post 1 April 1974 businesses to ensure, among other things, that profits not less than the total profits made over the life of the business are assessed. This is because, as mentioned above, for a business which started after 1 April 1974 the assessments will equal in total the profits earned during the life of the business if accounts are consistently made up to the same day in each year.

We have next to consider whether the Commissioner is right in proceeding on the basis that although the Ordinance does not in terms prohibit him from adopting a period of less than twelve months as the basis period the norm is twelve months. The adoption of the norm in any particular case, of course, does not mean that the Commissioner is left with no other effective exercise of discretion since he has still to decide which twelve months period should be adopted and how the profits and losses are to be apportioned to which periods.

In the Helical Bar case cited by the Revenue and considered further below, the relevant legislation (section 127 of the Income Tax Act 1952 as amended) gave the Commissioners power in certain circumstances (including an alteration in the period of account) ‘to decide what period of twelve months ending on a date within the year preceding the year of assessment shall be deemed to be the year the profits or gains of which are to be taken to be the profits or gains of the year preceding the year of assessment’.

Our section 18E does not restrict the Commissioner’s discretion to decide what period of twelve months shall constitute the basis period and the Revenue has not argued that it does nor has the Commissioner proceeded on the basis that his discretion is thus restricted by section 18E in respect of ‘old established businesses’.

Nevertheless, in the case of an old established business the accounting year is still retained to give the measure of profits for a year of assessment and we think that the scheme of Ordinance is such that, irrespective of the accounting dates adopted, a twelve months basis period for any year of assessment is the norm (leaving aside such statutory exceptions as those which relate to the commencement and cessation provisions in sections

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18C and 18D). We think that as a general rule it is perfectly proper in the exercise of discretion under section 18E for the Commissioner to seek to ensure (as one of his stated objectives) a basis period of twelve months for any year of assessment [although in the case of businesses which commenced on or after 1 April 1974 there is express authority to the Commissioner to adopt a basis period of more than twelve months].

The above analysis does not dispose of this appeal because it is still necessary to consider whether on the facts of this particular case the discretion has been exercised on a fair and proper basis and the assessment correctly made.

In Commissioners of Inland Revenue v Helical Bar Ltd [1972] 48 TC 221, it was recognised that there is a distinction between double taxation and double use of profits and that an overlapping of basis periods resulting in the double use of profits does not (at least in the context of the UK legislation) necessarily of itself give rise to any injustice. In the House of Lords, Lord Wilberforce (at page 255) said:

‘It is clear that, in the first place, that no injustice arises from the mere fact that there was a nine months’ overlap that is that some 18,000 pounds sterling of profits, those from 1 May 1962 to 31 January 1963, entered into two years’ assessments. This double computation, or double use of profits for two years’ assessments, is a phenomenon frequently found in income tax law: it may happen whenever there is a change of accounting period. Injustice can result if the doubly used profits are unusually high (not this case) but not from the double use itself.’

It must be emphasised that these observations were made in the context of the UK legislation; however the distinction between double use and double taxation, and the point that injustice does not necessarily result from overlap, are points which are not without relevance in the context of our Ordinance.

The Commissioner in the present case adopted a basis period of twelve months to 30 September 1986 after considering, among other things, ‘the trend of profits’ insofar as that was discernible at the time. We find that the adjusted profits before depreciation allowances as well as its level of operating income for the period 1 March 1985 to 30 September 1988 is as follows:

	Year ended <u>28-2-86</u> \$	7 months ending <u>30-9-86</u> \$	Year ended <u>30-9-87</u> \$	Year ended <u>30-9-88</u> \$
Adjusted Annual Profits	3,102,023	1,911,452	1,977,530	5,841,228

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Monthly Average	258,502	273,064	164,794	486,769
Tax Rate	18.5%	18.5%	18%	17%

Operating Income	21,302,902	12,858,853	23,394,141	33,038,147
(Operating Expenses)	(18,939,881)	(12,943,541)	(23,110,688)	(30,719,734)

Thus on the basis selected by the Commissioner the doubly used profits amounted to a monthly average of \$258,502. It is therefore clear that profits of the years of assessment 1985/86 and 1986/87 are of a comparable level (\$3,100,000 as compared with \$3,270,000).

<u>Doubly used Profits</u>	<u>Annual Adjusted Total</u> \$	<u>Monthly Average</u> \$
(that is year ended 28-2-86)	3,102,023 =====	258,502 =====
Change of Accounting Date (that is 7 months ending 30-9-86)	1,911,452 =====	273,064 =====
say 12 months adjusted total (1,911,452 x 12/7)	3,276,774 =====	273,064 =====

It is also clear that had the Commissioner selected a different twelve months period as the basis period say a twelve months period ending 28 February 1987, the annual adjusted profits would be in the region of \$2,700,000 (monthly average of \$227,951) as compared with the selected basis (year ended 30 September 1986) of around \$2,500,000 (monthly average of \$212,477); that would have led to higher assessable profits payable by the Taxpayer.

On the other hand had the Taxpayer's proposed seven months period been adopted there would have been a five months tax deferral effect.

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		(Tax Rate)
Y/A 86/87	7 months ending 30-9-86 (5 months ending 28-2-87 deferred)	18.5%
Y/A 87/88	Profits Deferred: \$(5 x 164,794) : \$823,970	18%
Y/A 88/89	\$(5 x 486,769) : \$2,433,845	17%
Y/A 89/90	#\$ (5 x 486,769) : \$2,433,845	18.5%

[# Assumptions based on there being no section 63J hold-over claim to the provisional profits tax for the year of assessment 1989/90 raised on the Taxpayer.]

The Taxpayer contends that the financial benefits flowing from the deferral amounted to no more than \$20,000 or thereabouts and that this can be countered by the Commissioner needing to assess a further sum of only around \$110,000.

We do not doubt the figures mentioned but are of the view that the discretion of the Commissioner under section 18E is not restricted to choosing a basis period which would counter any supposed fiscal advantages such as a deferral effect which the Taxpayer might hope to gain by changing the accounting date; we find that the discretion can properly be used to achieve the objectives stated by the Commissioner and was in fact fairly and properly exercised on the facts of the present case.

As suggested by the Taxpayer in the course of argument that even after adopting a twelve months basis period for the year of assessment the Commissioner could have reduced the assessable profits by a 'counter-figure' which would have the effect of assessing to profits only such sum as would be needed to counter the advantages perceived to be gained by the Taxpayer by the change in its accounting date. We do not think that the Commissioner could do that or that it would have been a proper exercise of discretion. Section 18E does not give him a discretion to levy such tax as he thinks fit but to only compute the assessable profits on such basis as he thinks fit.

We do not think that it makes any difference that the change in the accounting date was not motivated by a desire to achieve a deferral of tax but was, consequent upon the acquisition by another company of the Taxpayer, to ensure uniformity of accounting dates amongst the group for consolidation purposes.

In the course of his able submission the Taxpayer's representative, Mr Smith, has referred us to a number of cases on the exercise of discretion, including Sharp v Wakefield [1891] 1 AC 73, The Metropolitan Gas Co v Federal Commissioner of Taxation [1949] 9 ATD 5. There is no dispute that the Commissioner has to consider all relevant

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factors and disregard all irrelevant factors in the exercise of his discretion. He must direct his mind to what is the appropriate basis for computation or recomputation of profits on the facts of the case. We are unable to say that he has not done so or that the Taxpayer has otherwise discharged the onus under section 67(5)(d).

We dismiss the appeal and confirm the assessment accordingly.