Case No. D73/91

Profits tax – interest income – whether interest accrues over a period of time or at the moment when it is due for payment.

Panel: William Turnbull (chairman), Benjamin Kwok Chi-bun and Brian S Mcelney.

Dates of hearing: 3 & 6 December 1991.
Date of decision: 10 March 1992.

The taxpayer was a company carrying on business in Hong Kong. It was a member of a larger group of companies. The taxpayer placed money on deposit outside of Hong Kong and prior to the law being amended in 1984 the interest income was not subject to Hong Kong profits tax. The law was amended with effect from 1 April 1984 making offshore interest income taxable in Hong Kong. The taxpayer had a number of fixed deposits which were placed before 1 April 1984 and which did not mature until after the new law came into effect. The Commissioner was of the opinion that interest does not accrue over a period of time but accrues on the date when it becomes payable and accordingly all of the interest on deposits which matured after the effective date of the new legislation were assessable to profits tax in Hong Kong. The taxpayer appealed to the Board of Review.

Held:

Interest income accrues due over a period of time and not on the date when it becomes payable. Accordingly the interest income was not taxable in Hong Kong.

Appeal allowed.

Cases referred to:

Re Rogers' Trust 1860 1 Drew v Sur 338
Bryan v Cassin 24 TC 468
Wigmore v Thomas Summerson and Sons Ltd 9 TC 577
Whimster & Co v CIR 12 TC 813
CIR v Lo and Lo [1984] 1 WLR 986
D13/84, IRBRD, vol 2, 112
D14/88, IRBRD, vol 3, 206
CIR v Hang Seng Bank Limited [1989] 2 HKTC 614
Willingale v International Commercial Bank Ltd [1978] 2 WLR 452

P F Feenstra for the Commissioner of Inland Revenue.
John Gardiner instructed by Woo, Kwan, Lee & Lo for the taxpayer.

Decision:

This is an appeal by a company incorporated in Hong Kong. The appeal originally related to three matters in dispute, namely, (i) what parts of the plant and machinery are designed to qualify for accelerated depreciation allowances, (ii) whether interest income accrues over a period of time or at the moment when it is due for payment, and, (iii) what was the profit arising on the sale of certain assets which were capital assets and not subject to profits tax. Prior to the hearing of the appeal, the first and third matters were settled between the Commissioner and the Taxpayer.

With regard to the first matter, a schedule was tabled before the Board of the items which the Commissioner and the Taxpayer respectively agreed were or were not plant and machinery for the purposes of depreciation allowances. The board accepted the schedule and ordered that the two assessments which are the subject matter of this appeal should be adjusted accordingly.

With regard to the third matter, the representative for the Commissioner informed the Board that the Commissioner accepted that the profit arising from the sale of the capital assets was as claimed by the Taxpayer. The Board of Review accepted this and ordered that the relevant tax assessment should be reduced accordingly.

The second ground of appeal relating to when interest accrues was disputed between the parties and the Board proceeded to hear the appeal so far as this ground is concerned. The facts are quite simple and are as follows:

1. The Taxpayer is a company incorporated in Hong Kong which is a member of a company group. One of the functions performed by the Taxpayer within the group was to act as the 'banker' for the group companies. The Taxpayer was not a licensed bank.

2. The Inland Revenue (Amendment) Ordinance 1984, inter alia, amended sections 15(1)(f) and (g) of the Inland Revenue Ordinance subject to the terms of section 15(4) thereof. The nature and intent of the amendments was to bring within the charge to profits tax interest income notwithstanding that the moneys in respect of which the interest was received or accrued were made available outside Hong Kong. In 1986 further amendments were made to the Inland Revenue Ordinance which had the general effect of reversing the provisions of the Inland Revenue (Amendment) Ordinance 1984 so far as interest was concerned. The effect of the foregoing was that during the period from 1 April 1984 up to and including 31 March 1986 interest on certain

offshore deposits not previously nor subsequently taxable became subject to profits tax in Hong Kong.

3. In early 1984, the Taxpayer had a number of existing fixed term deposits with various banks in foreign currency which had been made available to the banks outside Hong Kong. It is the interest on these fixed term deposits which is the subject matter of this appeal. It is not necessary for the purposes of this decision to set out in full all of the deposits which are the subject matter of this appeal. Particulars of the same can be found in the appendices to the determination of the Commissioner dated 11 March 1989.

4. The financial year end of the Taxpayer was 31 December. The Taxpayer apportioned on a daily basis interest on fixed term deposits with banks which had been placed before the year end and which did not mature until some time in the following year. The interest for the period up to 31 December was credited to one year and the interest thereafter to the next year. This was done for the year ended 31 December 1984.

5. For the purposes of its profits tax return, the Taxpayer apportioned the interest income which it received on the various fixed term deposits which had been placed on deposit prior to 1 April 1984 and which did not mature until after 31 March 1984. The interest in respect of the period prior to 1 April 1984 was considered by the Taxpayer not to be subject to Hong Kong profits tax on the basis that it had accrued prior to that date.

6. The assessor did not accept the calculation of interest subject to Hong Kong profits tax as made by the Taxpayer and was of the opinion that all of the interest on any fixed term deposits which did not mature until after 31 March 1984 was subject to Hong Kong profits tax by virtue of the provisions of the Inland Revenue (Amendment) Ordinance 1984. The assessor charged all such interest to tax in the tax assessment which he issued for the year of assessment 1984/85. The Taxpayer objected to this assessment but the same was confirmed by the Commissioner by his determination dated 11 March 1989. The assessment was confirmed subject to certain adjustments thereto which are not material to the matter in dispute between the parties in this appeal.

7. The Taxpayer duly appealed to the Board of Review against the determination of the Commissioner.

At the hearing of the appeal, a number of witnesses were called to give evidence on behalf of the Taxpayer. They comprised a group treasury and investment manager who was responsible at the time for making the fixed term deposits with the banks which are the subject matter of this appeal, a partner of a firm of certified public accountants who were the auditors for the Taxpayer at the time, and a number of bank managers who were managers of some of the banks with whom the Taxpayer made fixed term deposits at the time in question. The witnesses gave their evidence in chief and were cross-examined.

However, with due respect, we found their evidence to be of limited value. It appears to us that the facts relating to the fixed term deposits are simple and incontrovertible. The Taxpayer sought to show that the moneys placed on deposits were in effect 'at call' at any moment of time. This we cannot accept. The additional facts relating to the fixed term deposits are as follows:

1. It was the practice of the Taxpayer to make fixed term deposits from time to time using moneys which the Taxpayer had and which were surplus to group requirements at that moment in time.

2. The group treasury and investment manager would make decisions with regard to the term of the fixed deposit which would depend upon the interest rates quoted and the cash requirements of the company group of which the Taxpayer was a member. Generally the intention was that the term would not exceed three months and six months would be exceptional.

3. Banks would quote different rates of interest for different fixed periods of time.

4. The fixed term deposit comprised a contract between the Taxpayer and the bank in question. Under that contract the Taxpayer agreed to lend to the bank a certain sum of money for a certain fixed period of time. In return, the bank undertook to repay the Taxpayer the amount it deposited together with interest thereon calculated at the agreed rate for the agreed period of the fixed deposit with such interest payable when the deposit matured at the end of the agreed period.

5. If a customer, including the Taxpayer, wished to break the term of a fixed deposit and withdraw the funds before maturity, the bank would consider such request on a case by case basis but with no legal obligation to accept such request. It was customary in normal circumstances for a bank to agree to allow a depositor to uplift a deposit before its maturity subject to the depositor agreeing to pay a fee to cover the administrative expenses of the bank and to compensate the bank for the early withdrawal of the funds. The compensation amount would be equal to the difference between the amount of interest which the bank would have had to pay the depositor for the remainder of the fixed term and the amount which the bank would have to pay in the open market to replace he funds which were being uplifted. If the fixed term deposit was withdrawn at a very early date, it could mean that no interest would be paid or that the depositor might have to pay compensation in addition to forfeiting interest.

6. The Taxpayer had no right to withdraw funds placed on fixed term deposit prior to maturity. Unless the bank agreed to early withdrawal, no interest was payable until the maturity date of the fixed term deposit.

The Taxpayer was represented by leading counsel who drew our attention to the fact that the law in relation to interest on offshore deposits had been amended by the Inland Revenue (Amendment) Ordinance 1984. He said that the effect of the amending Ordinance was to bring within the scope of profits tax interest on offshore deposits. He said that the law before during and after the period in question remained the same as far as this case is concerned. He said that the Inland Revenue Ordinance made 'sums received by or accrued to' any person 'by way of interest' chargeable to profits tax. He drew our attention to section 15(4) of the Inland Revenue Ordinance which provides specifically that the provisions of the 1984 Amending Ordinance 'shall not have the effect of rendering chargeable to tax sums received by or accrued to any person prior to 1 April 1984 which were not chargeable to tax immediately prior to the coming into force of that Ordinance'. The 1986 Amending Ordinance which restored the law substantially to its previous format had a similar provision in relation to interest received or accrued prior to 1 April 1986.

Leading counsel pointed out that in section 15 most of the sub-paragraphs use the phrase 'received by or accrued to'. He submitted that the word 'accrued' is not a synonym for 'received'. He pointed out that section 28 of the Inland Revenue Ordinance charges interest tax on 'any sum paid or credited'. These words are clearly different in relation to interest tax as compared to profits tax.

He said that few businesses operated on a cash basis and that most businesses compute their profits and losses on an earning's basis in accordance with fundamental accounting concepts including accounting for accruals. He pointed out that businesses would accrue interest in the same day as the Taxpayer had in this case and likewise banks would accrue their liability to interest. He said that it was interesting to note the distinction between sections 15 and 28 of the Ordinance which clearly showed that the law drew a distinction between interest earned by businesses and interest earned by private individuals. He said that the word 'accrue' did not mean 'receivable'.

Leading Counsel then drew to our attention the following cases:

Re Rogers' Trust 1860 1 Drew v Sur 338

Bryan v Cassin 24 TC 468

Wigmore v Thomas Summerson and Sons Ltd 9 TC 577

Whimster & Co v CIR 12 TC 813

CIR v Lo and Lo [1984] 1 WLR 986

D13/84, IRBRD, vol 2, 112

D14/88, IRBRD, vol 3, 206

The Commissioner was represented by the Senior Assistant Crown Solicitor. He submitted that interest on time deposits accrues on the due dates when the deposits mature. He said that that is when the depositor becomes entitled to receive the interest. That is when the depositor has done everything which is required of him to earn the interest and until then he has not earned the interest. He said that the depositor may break the deposit or transfer his right to receive the deposit and the interest he will have in the future. He said that these were different transactions because before maturity, the depositor has a mere expectancy to receive interest in the future. The interest is only earned by and only accrued to the person who is entitled to the deposit at the date of maturity. He said that you do not become entitled to half of the interest when you have only completed half of the contract. He referred to the Wigmore case and pointed out that before the maturity of a deposit you cannot get any 'interest'. He said that the interest did not exist before that date and therefore cannot be earned, payable, received, accrued, receivable, or credited. He drew our attention to CIR v Hang Seng Bank Limited [1989] 2 HKTC 614 case where the Court of Appeal had said that the true nature of the transaction was sale and purchase of an expectancy and not accrued interest.

He also referred us to Willingale v International Commercial Bank Ltd [1978] 2 WLR 452 case and said that ordinary business tests did not apply where they ran counter to the principles of income tax. He said that interest may be shown in the accounts but that does not affect the tax liability of the Taxpayer.

The question for this Board to answer is 'what is the meaning of the word "accrue" as it is used in the Inland Revenue Ordinance in relation to interest which may be assessable to profits tax?' It is perhaps surprising that such a simple question should not have come for determination previously and that there should be any doubt. Perhaps the matter has not arisen in the past, because it has not been very material. It seems that tax returns prepared on the basis which the Taxpayer has use in this case have been accepted both before and after the year in question. Whilst prior and subsequent practice do not change the law it does suggest some inconsistency. Because of the change in the tax law, the Commissioner is now seeking to argue that the word 'accrue' is the equivalent of 'becomes payable'. With this submission we find little sympathy. In our opinion this is a mis-guided attempt by the Commissioner to charge to tax income which had been earned prior to 1 April 1984 and which if held to accrue prior to that date would not be taxable.

It is the intent of the legislature that a businessman, trader, or industrialist should pay tax on the net profits which he earns during a particular period. Subject to certain exceptions, it is not the intention of the Inland Revenue Ordinance to create a new system of accounting. It is the intention that common sense should prevail and the normal rules and practices of carrying on business should be followed. The facts of each particular case and of each particular business must be looked at before any answer can be given. Clearly there can be exceptional circumstances which would lead to exceptional results. However, the case before is not exceptional and is a simple example of the placing of fixed term deposits with banks which occur as routine transactions on countless occasions. If we were to accept the Commissioner's submission, we would open the door to the most unusual and distorted results which would be a dream world come true for tax planners. We cannot

accept the proposition that interest does not accrue to a person until it becomes due and payable. If this were the situation for tax purposes, then it would be possible for a person to defer paying tax by placing money on deposit for long periods of time. It would be possible to lock up surplus moneys for long periods of time earning tax free interest. However, the dreams of tax planners would be the nightmares of banks who would have to have huge contingency accounts into which they could debit interest on long term deposits where the interest had not yet accrued for taxation purposes and could therefore not yet be deducted as an expense.

The Inland Revenue Ordinance uses the word 'accrue' in relation to income including interest and not the words 'accrue due' or the words 'become payable' or 'received'. The Inland Revenue Ordinance uses the simple word 'accrue' and in our opinion this is intended to be used in the normal accounting sense. Indeed the Ordinance in section 15 frequently uses the words 'received by or accrued to' in relation to income subject to profits tax. It is the clear intention of these words to bring into the tax net not just moneys received but also profits as they are earned according to ordinary and accepted accounting principles.

It would be wrong if a company in maintaining its accounts and publishing its audited figures were to ignore interest as an income item or expense until such time as it becomes payable. It is basic and fundamental corporate accounting practice to accrue such items as they are incurred or earned. For example and as is the case of the Taxpayer, if a company's financial year ends on 31 December then it would be customary to calculate interest income and expenses up to and including that day on a pro rata daily basis. In our opinion the same calculation should be made for the conclusion of the tax or fiscal year. We do not believe that it was the intention of the legislature that some completely different and new accounting concept should be applied for taxation purposes only. The taxable income of the Taxpayer should follow its normal sound accounting principles. Accounts should only be re-written or adjusted for tax purposes where there is a clear statutory requirement so to do, as is the case with depreciation allowances which by statute may be more or less than the amounts provided by a company in its accounts.

In the course of hearing the appeal, no reference was made to other fixed deposits which either the Taxpayer or others may have had and how interest on the same has been treated for tax purposes. In this case the Commissioner is seeking to give the provisions of the Inland Revenue (Amendment) Ordinance 1984 some form of retrospective effect in relation to a number of offshore deposits. If however it had been past practice to tax interest on this basis we assume that the Commissioner's counsel would have told us. Obviously, it would be wrong to have different rules for the calculation of interest for taxation purposes on offshore deposits in the two year period from 1 April 1984. If the word 'accrue' means 'accrue and be payable' then the same rule must apply to all interest on all fixed term deposits.

For the reasons given we find in favour of the Taxpayer and direct that the assessment against which the Taxpayer has appealed should be referred back to the Commissioner to make the necessary adjustments to exclude interest on the fixed term

deposits in question in relation to the period prior to 1 April 1984. As there may be a number of adjustments to be made to implement our decision the parties are given leave to refer back to the Board in the event of their being unable to reach agreement with regard to the same.