

Section 16(1)

[7970]–[8010]

The meaning of section 16(1) was closely analysed in the decisions at first instance and on appeal in *CIR v Lo & Lo* (1984) 2 HKTC 34; [1984] 1 WLR 986 (see also [1982] HKLR 179 and [1982] HKLR 503, CA). In the Court of Appeal, Leonard VP at [1982] HKLR 509 paraphrased section 16(1) as follows:

‘In order to ascertain the taxable profits you shall deduct from the total of receipts and sums deemed to be receipts all outgoings and expenses to the extent to which they are incurred in the production of such profits.’

[8011]

‘*In ascertaining the profits*’ It was decided in *CIR v Lo & Lo* that the process of ascertaining profits involves the application of the principles of proper commercial accountancy practice in relation to both receipts and deductible expenditure subject to specific legislative qualification as exists in section 17(1) in particular. Lord Brightman observed at (1984) 2 HKTC 71:

‘Sections 16 and 17 provide exhaustively for deductions in the sense that permitted deductions are confined to outgoings and expenses incurred in the production of profits in respect of which tax is chargeable; that such permitted deductions expressly include those specified in (a) to (h) of section 16(1), and expressly exclude those in section 17. In the opinion of their Lordships commercial considerations are not wholly to be disregarded in the course of this process. They are relevant for the purpose of deciding what can properly be treated as “outgoings and expenses . . . incurred during the basis period . . . in the production of profits in respect of which . . .” the taxpayer is chargeable to tax.’

It is clear from both the Ordinance and authority that a profit and loss account produced in accordance with the Companies Ordinance can differ from a computation of assessable profits for profits tax purposes, although it also seems apparent, following *CIR v Secan Ltd*, discussed at II [5761.1], that generally accepted accounting principles are arguably influencing profits tax computations in Hong Kong to a greater extent than ever before (see generally, Halkyard and Shek, ‘Relationship Between Accounting and Taxation Principles’ (2002) *Asia-Pacific Tax Bulletin* (May/June) 143.

[8012]

The two-stage approach of first ascertaining the full receipts in accordance with commercial accountancy practice and then secondly, and separately, ascertaining permissible deductions in accordance with statutory standards has been held to be inappropriate in the context of determining assessable profits for Hong Kong profits tax purposes. In *Lo & Lo*, the Court of Appeal expressly followed the United Kingdom decisions in *Southern Railway of Peru v Owen* [1957] AC 334 and *IRC v Titaghur Jute*

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Factory Co Ltd [1978] STC 166 in preference to the leading Australian authorities *New Zealand Flux Investments Ltd v FCT* (1938) 61 CLR 179, *FCT v James Flood Pty* (1953) 88 CLR 492 and *Nilsen Development Laboratories v FCT* (1981) 11 ATR 505. Cons JA summarised the matter in this way:

'In my opinion Hong Kong falls within the [United Kingdom] pattern for although there are some particular instances set out in subsection 16(1) those instances are introduced by the word "including". That implies that there must be other deductible items which have not been specifically mentioned, and how are these to be found except by reference to normal accountancy practice, provided of course that they do not contravene the general words of the subsection.'

Although this statement seems entirely consistent with the Court of Final Appeal's decision in *CIR v Secan Ltd* (2000) 5 HKTC 266, it should be noted that Lord Millett NPJ expressly stated that section 16 is enacted for the protection of the Revenue, not the taxpayer, and must thus be read in a negative sense. In *Departmental Interpretation and Practice Notes No 40: 'Prepaid or Deferred Revenue Expenses'* (August 2010), at paragraph 11 (see III [40]) the Commissioner considers that this dictum means that section 16 cannot be used to justify any deduction for expenditure correctly recorded in a taxpayer's accounts; instead, section 16 allows a claim for deduction to be disallowed where the criteria in the section are not satisfied. At page 331, Lord Millett NPJ then went on to state that:

[Section 16] permits outgoings to be deducted *only* to the extent to which they are incurred in the relevant year. In this respect there is no difference between the law of Hong Kong and the law of England. In both jurisdictions expenses and outgoings are deductible in the year in which they are incurred and not otherwise.

[8013]

The fact that, in contrast with section 16(1), section 17(1) opens with the words 'For the purpose of ascertaining profits', while confusing, does not seem to be of any significance (*CIR v Lo & Lo* [1982] HKLR 503, CA, per Leonard VP at 509). The difference has occurred as a result of possibly unnecessary amendments made to section 16 following the decision in *CIR v Mutual Investment Co Ltd* [1967] AC 587; (1966) HKTC 185 (see per Leonard VP in *CIR v Lo & Lo* at 509).

[8014]

'*person*' The definition of 'person' in section 2(1) should be noted as this includes a partnership which is not a separate legal entity under the general law. The effect of treating a partnership as a de facto legal entity for tax purposes can cause problems with certain joint venture activities where the joint venturers each agree to contribute certain assets or expenses without these being taken over by the joint venture or partnership. For

example, a land development joint venture may proceed on the basis of one person providing the land, another the plant and labour force, and a third person the loan finance. In these circumstances the depreciation allowances for plant and machinery, the expense of the labour force and the interest payable on the loan finance will not be *incurred* in the production of profits by the joint venture unless they are expenses of the joint venture itself as a separate entity. At the same time if the profits from the venture are earned by the joint venture as a separate entity the joint venturers as individual persons will not have chargeable profits against which to charge their various allowances and expenses.

[8015]

'all outgoings and expenses' There is a difference between 'outgoings' and 'expenses'. The latter can extend to a liability that has been assumed and therefore has been 'incurred' (*CIR v Lo & Lo* [1982] HKLR 503 per Leonard VP at 509). In the Privy Council decision in *CIR v Lo & Lo* Lord Brightman observed at [1984] 1 WLR 991:

'In construing section 16, weight must be given to the fact that deductions are not confined to sums actually paid by the taxpayer.

Such sums would be covered by the word "outgoings" standing alone. The contrast between "sums payable" in paragraph (a) and "rent paid" in paragraph (b) and the inclusion in paragraph (d) of "bad debts incurred" show clearly enough that the legislature was not thinking only of disbursements made during the basis period.'

[8016]–[8055]

In *D 55/95* 11 IRBRD 10 a debt owed to an engineering company for the amount of a bank deposit by an insolvent bank was held to be neither an outgoing nor an expense. Rather, it was simply a loss and the general terms of section 16(1) do not permit the deduction of a loss, unless a specific statutory provision such as section 16(1)(d) applies (compare *D 144/98* 13 IRBRD 676 where the taxpayer's claim that it had incurred a deductible loss in investing in a film was denied, inter alia, on the basis that the amount in dispute was simply a non-deductible loan and *D 58/02* 17 IRBRD 834 where a claim to deduct a rental deposit that was written off was denied on the basis that it did not qualify as an outgoing or expense).

[8056]

Only expenditure of an income or revenue nature is deductible because expenditure of a capital nature is specifically disallowed (section 17(1) (c)). Allowances for depreciation may however be possible under Part VI. In addition immediate and accelerated deductions are allowed in the case of capital expenditure relating to certain intellectual property rights (see sections 16(1)(g), 16E and 16EA), special payments under a recognised retirement scheme (section 16A), scientific research (section 16B), renovation or refurbishment of non-domestic buildings or structures (section