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TAX LAW AND ACCOUNTING PRINCIPLES

I. INTRODUCTION

SECTION 10(1)(a) of the Income Tax Act[1] provides that tax shall be payable on the income of any person accruing in or derived from Singapore or received in Singapore from outside Singapore in respect of *gains or profits* from any trade, business, profession or vocation. The question of whether these *gains or profits* are to be determined by established accounting principles or are to be determined by judges afresh is a vexed one and has been the source of much debate.[2]

The recent cases of *Gallagher* v *Jones*[3] and *Johnston* v *Britannia Airways Ltd*[4] indicate a growing willingness by the courts in England to recognise that the matter should be determined on the basis of accounting principles. The aim of this article is to examine the merits of this trend and the other approaches adopted by the courts and to see to what extent these decisions are applicable in the local context.

II. THE VARIOUS APPROACHES

Accounting principles and revenue law can conflict in numerous ways and some of these conflicts will be referred to in the course of this article. But the first question that arises is that where there is indeed such a conflict, how have the courts attempted to resolve it thus far.

One approach has been to first determine the question as a matter of law and then to see whether accounting practice gives a different answer.[5] If it does the next step would be to determine whether there is any reason why the accounting practice should prevail. This was the approach taken

1 Cap 134 of the Statutes of the Republic of Singapore, 1994 Rev Ed.

2 See, for instance, ST Crump, "Accounting Profits and Tax Profits" [1959] BTR 323; R Burgess, "Revenue Law and Accountancy Practice" [1972] BTR 308 and J Freedman "Profits and Prophets – Law and Accountancy Practice on the Timing of Receipts" [1987] BTR 61.

3 [1994] 2 WLR 160.

4 [1994] STC 763.

5 See, Butterworths UK Tax Guide 1994-95 at 354.

in *ECC Quarries Ltd* v *Watkis*.[6]

In this case, the taxpayer company which was engaged in operating quarries applied for a planning permission which eventually turned out to be unsuccessful. The taxpayer company sought to deduct the abortive expenses incurred in applying for the permission on the basis that accounting practice recognised the deductibility of such expenses. However, the court held that as a matter of law, the expenditure was capital in nature and hence not deductible and that there was no reason why the accounting practice of allowing the deduction should prevail.

Another approach has been to first determine the question from the viewpoint of accounting practice and then to see whether it conflicts with any statutory provision or rule of law.[7] It will be appreciated that this approach gives accounting practice much greater weight then the first. This was the approach taken by Salmon LJ in *Odeon Theatres Ltd* v *Jones*.[8] In this case, the issue concerned the correct tax treatment of sums spent by the taxpayer company on the repair of cinemas it had acquired. Though, some of these repairs related to the use before the company had acquired the cinemas, accounting practice recognised the deductibility of these expenses. The court accordingly allowed the deduction since the established accounting practice did not conflict with any particular statutory provision or rule of law.

The latest approach, which marks a decisive move towards giving accounting practice even greater recognition, is that enunciated in *Gallagher* v *Jones*.[9]

In this case, the taxpayer leased boats from a finance company and there was heavy front-end loading of the rental payments. The issue arose whether these rental payments were deductible when incurred or whether they could be spread out evenly throughout the period of the lease. The crown contended that ordinary principles of commercial accounting were the proper basis for ascertaining the profits or losses of a trade and that there was no principle of income tax law which precluded or restricted the application of such principles which, in the present case, were embodied in Statements of Standard Accounting Practice SSAP 2 and SSAP 21. Harman J[10] in the High Court held that the, "actual expenditure properly incurred and referable to the trade is properly chargeable in the accounts for the year in which

6 [1975] STC 578.

7 See, *supra*, note 5.

8 [1972] 1 All ER 681 at 689. See also Lord Haldane in *Sun Insurance Office Ltd* v *Clark* [1912] AC 443 at 455 and Lord Clyde in *Lothian Chemical Co Ltd* v *Rogers* (1926) 11 TC 508 at 520.

9 *Supra*, note 3.

10 [1993] STC 199 at 216.

it falls due notwithstanding that prudent and proper principles of commercial accounting would draw the commercial accounts of the trading enterprise on a different basis and would spread forward the actual expenditure incurred over future years so as to give a more balanced view of the nature of the success or failure of the trade". The Court of Appeal however, reversed the decision of Harman J

Sir Thomas Bingham MR in the Court of Appeal, after an extensive review of all the authorities, stated[11] *inter alia* that, "No judge-made rule could override the application of a generally accepted rule of commercial accountancy which (a) applied to the situation in question, (b) was not one of two or more rules applicable to the situation in question and (c) was not shown to be inconsistent with the true facts or otherwise inapt to determine the true profits or losses of the business". Sir Thomas Bingham MR's judgement has now been followed in *Johnston* v *Britannia Airways Ltd*[12] where Knox J[13] held that the court will be slow "to accept that accounts prepared in accordance with accepted principles of commercial accountancy are not adequate for tax purposes as a true statement of the taxpayer's profits for the relevant period".

Thus, the current position in England appears to be that the courts will generally be bound by established accounting principles in determining the *gains or profits* for income tax purposes from any trade, business, profession or vocation. But, before we look at the merits of this or the other approaches, it is first important to understand fully the scope of Sir Thomas Bingham MR's statement in *Gallagher* v *Jones.*[14]

It must be pointed out that Sir Thomas Bingham MR was only referring to judge-made law. Thus where there is an express statutory provision to the contrary, quite clearly accountancy practice will be irrelevant. Thus, while accountancy practice would write off capital expenditure incurred on any asset over its lifetime, tax law will only allow deduction if the expenditure falls within the capital allowances system provided for in the Income Tax Act.

Secondly, some judge-made law may be too well established to be overridden by accountancy practice. Thus, the question of what is revenue and what is capital, it would appear is a question of law to be determined by courts[15] and not by accounting practice, even though there is no express statutory provision on the matter.

11 *Supra*, note 3, at 182.
12 *Supra*, note 4.
13 *Ibid*, at 782.
14 *Supra*, note 3.
15 See, for instance, *ECC Quarries Ltd* v *Watkis* [1975] STC 578; *Associated Portland Cement Manufacturers Ltd* v *Kerr* [1946] 1 All ER 68; *Heather* v *PE Consulting Group* [1973] 1 All ER 8 and *Beauchamp* v *FW Woolworth plc* [1989] STC 510.

Thirdly, as Sir Thomas Bingham MR stated the court is not bound by a particular accounting practice if the accountancy profession itself knows of more than one approach or method. The case of *Ostime* v *Duplex Motor Bodies Ltd,*[16] which concerned the valuation of work-in-progress for tax purposes, illustrates the point. In this case the company had in the past adopted a 'direct cost' basis, charging only the direct cost of materials and labour expended on the work. The Crown contended for an 'on-cost' basis, which would add to the direct cost an appropriate proportion of indirect expenditure, such as overheads. There was evidence that either basis was regarded as satisfactory by accountants. The court held that the 'direct cost' method was to be followed as it was "less likely to violate the taxing statute."[17] The court in this case was not bound by the "on-cost" method as it was not the only one known to the accountancy profession.

Fourthly, also as Sir Thomas Bingham MR stated, if the accounting practice is for some reason inapt to determine the true profits or losses of the business, then it is not binding. The case of *Willingale* v *International Commercial Bank Ltd,*[18] illustrates the point. In this case the bank concerned bought bills of exchange at a discount and the issue arose whether the bank could bring into account each year, a fractional part of the profit which it expected to make if the bills were held to maturity or sold. There was evidence of accounting practice which allowed a proportion of profits to be taken every year. However, the court held that this could not be done as the *exact* amount of the profit could not be ascertained before the bill was actually sold or matured. Since to have followed the accounting practice in this case would have let to a misleading picture of the profits of the business, the accounting practice was held not to be binding.

III. Commentary

In order to determine which of these various approaches should be adopted, it is submitted, it is first necessary to determine whether the term *gains or profits* is a technical one and hence a question of fact to be determined by accountants or an ordinary one and hence a question of law to be determined by judges. Unfortunately there are statements in cases which support either view.

One view is that the term *gains or profits* is an ordinary one and hence it is a question of law to be determined by judges. Thus Lord Denning in *Heather* v *P-E Consulting Group Ltd*[19] stated, "The courts have always

[16] [1961] 2 All ER 167.
[17] *Ibid*, at 171.
[18] [1978] STC 75.
[19] [1973] 1 All ER 8 at 13.

been assisted greatly by evidence of accountants. Their practice should be given due weight, but the courts have never regarded themselves as being bound by it. It would be wrong to do so. The question ... is a question of law for the courts. They are not to be deflected from their true course by evidence of accountants, however eminent". Similarly, Buckley LJ in *Odeon Associated Theatres Ltd* v *Jones*[20] stated, "In answering that question of law it is right that the court should pay regard to the ordinary principles of commercial accounting so far as applicable. Accountants are, after all, the persons best qualified by training and practical experience to suggest answers to the many difficult problems that can arise in this field. Nevertheless, the question remains ultimately a question of law."[21]

This view is open to criticism. If accountants are, after all, the persons best qualified by training and practical experience to suggest answers to the many difficult problems that can arise in this field, it is difficult to see why the question should still be a matter of law.[22] It can also be said that in today's highly complex commercial transactions the question of *gains or profits* should be left to accountants,[23] just like issues of medicine or engineering, are questions of fact left to determined by experts. It can also be argued that the well established views of an entire profession are more likely to be correct and the views of a few judges.[24]

The other view is the term *gains or profits* is a technical one and hence, it is a question of fact to be determined by accounting practice. Viscount Haldane in *Sun Insurance Office* v *Clark,*[25] for instance, stated, "It is plain that the question of what is or is not profit or gain must primarily be one

[20] [1972] 1 All ER 681 at 694.

[21] This also appears to be the position in Australia. See, for instance, *FCT* v *James Flood Pty Ltd* (1953) 5 AITR 579 at 585.

[22] As Sir Christopher Slade stated in *Gallagher* v *Jones* (*supra*, note 3, at 189), commercial accounting practice affords "the surest means of ascertaining the true profits or losses of a trader".

[23] As Lord Nolan stated in *Gallagher* v *Jones* (*supra*, note 3, at 187), " If we reject the statements of approved accountancy practice ... then where are we to look for the criterion?".

[24] The case of *Sharkey* v *Wernher* [1955] 3 All ER 493, illustrates the problem of leaving the matter to the discretion of judges. In this case the taxpayer had appropriated a trading stock for her own use and the issue arose whether the cost or market price of the stock ought to be imputed to her. The established accounting practice was to impute the cost price. This was also the position in America. However, the court imputed the market price as it made 'better economics'. It is difficult to see how this makes 'better economics' for to impute market price would distort the profits of the taxpayer as she did not actually receive that sum of money. On this ground this decision has been severely criticised, see, for instance, Potter, [1964] BTR 438. But basically this case illustrates the problem of leaving the matter to the judges who have no training in the field of accountancy.

[25] [1912] AC 443 at 455.

of fact, and of fact to be ascertained by the tests applied in ordinary business".

However, this view too is not free from criticism. This is because as Lord Radcliffe stated in *Southern Railway of Peru Ltd* v *Owen,*[26]

> "The requirements that an auditor may make before signing a balance sheet ... do, no doubt, cover his opinion that the account gives a 'true and fair view' of the profit for the financial year, but I do not think that such requirements are necessarily the same thing as the auditor's opinion that some particular provision could not be omitted without compromising the true and fair view. It is not possible completely to equate the balance shown by a company's profit and loss account with the balance of profit arising from the trade for the year.... I think that one is bound to say that references to an auditor's duty under the Companies Act, 1948, take us into a field that is not exactly the same as that in which the annual profits of trade should be ascertained for the purposes of income tax".

Thus there may be situations in which it may be inappropriate to follow accounting practice, as was the case in *Willingale* v *International Commercial Bank Ltd.*[27]

Both views are therefore open to criticism. Perhaps there is yet another view that the term involves a mixed question of law and fact. This follows from Sir Thomas Bingham MR's judgement in *Gallagher* v *Jones.*[28] His lordship in this case approached the issue essentially on the basis that the term *gains or profits* is a question of fact to be determined by accountants. However, if for some reason the accounting practice is inapt to reflect the true state of the profits or loss, then the judges may determine the matter afresh.

It is submitted this view is better than either of the other views expressed above. This is so for several reasons. Firstly, it gives due recognition to accounting practice. Secondly, it also creates certainty in that taxpayers will be able to plan their tax liabilities accurately in advance knowing that the courts will accept established accounting practice. Finally, this approach also has a certain amount of flexibility is that if for some reason the accounting practice is inapt to reflect the true state of the profit or loss, then the court can substitute it's own opinion.

[26] [1956] 2 All ER 728 at 741.
[27] *Supra*, note 18.
[28] *Supra*, note 3.

IV. The Position in Singapore

Thus far we have considered mainly the position in England. The question that arises next is whether the position in Singapore is or should be any different.

In *CIR* v *Lo and Lo,*[29] a Privy Council decision on appeal from Hongkong, the issue arose whether certain retirement benefits which had accrued were deductible, notwithstanding the fact that the employees in question had not left the employment of the taxpayer. It was not in dispute that good accounting practice allowed such a deduction and that in England these sums would have been deductible. However, the counsel for the Hongkong tax authorities argued that the Hongkong Inland Revenue Ordinance was fundamentally different from the UK Act in that it provided exhaustively for the items which could be deducted and hence unlike in the UK, reference should not be made to accounting practice. The Privy Council held that the section in question was indeed exhaustive, but nonetheless went on to hold that on the true construction of the section, the sums were deductible. It would also appear from the judgement that while it is permissible to look at commercial practice it is not to be treated as binding as the sections relating to deductions are exhaustive.

The Singapore Income Tax Act[30] is similar to the Hongkong Revenue Ordinance in this regard and it would follow from *CIR* v *Lo and Lo*[31] that since the Singapore Income Tax[32] too provides exhaustively as to what items may be deducted, while accounting practice may be referred to, it cannot be treated as binding. The actual words of the section must always be construed as a matter of law. Hence, regardless of the merits of the approach taken by the court in *Gallagher* v *Jones*[33] it is likely that it cannot be applied across the board in Singapore.

Nonetheless, it must be pointed out that *CIR* v *Lo and Lo,*[34] only dealt with deductions. There could be issues relating to what amount to *gains or profits* which do not involve any question of deductions as was the case in *Willingale* v *International Commercial Bank Ltd.*[35] The Singapore Income Tax Act,[36] like the UK Tax Act[37] does not state exhaustively what amounts

[29] [1984] 1 WLR 986 at 990.
[30] *Supra*, note 1.
[31] *Supra*, note 29.
[32] *Supra*, note 1.
[33] *Supra*, note 3.
[34] *Supra*, note 29.
[35] *Supra*, note 18. See also, *Symons* v *Weeks* [1983] STC 195.
[36] *Supra*, note 1.
[37] UK Income and Corporations Taxes Act 1988.

to a *gain or profit*. Thus in such situations, for the reasons discussed earlier, it is submitted, the approach taken by the court in *Gallagher* v *Jones*[38] is a welcome one and should be followed.

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[38] *Supra*, note 3.

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