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Common issues under tax audit by the Inland Revenue Department (IRD) - Deductibility of expenses

One would reasonably expect tax will only be imposed on profits earned. However, not all expenses incurred by a taxpayer can be claimed as tax deductible and hence reduce the amount of profits and tax thereon. If there is no tax deduction on the expenses incurred, that would mean that tax is imposed on the gross income. In some situations, the disallowance of expenses could result in double taxation. In this insight, we will look at the rules for allowing expenses deduction.

Section 16 and 17 of the Inland Revenue Ordinance (IRO) explain the general deduction rules, special deductions provisions and deductions that are not allowed. To qualify as deductible expenses, both sections have to be satisfied. Where there are irregular payments or the sum of payment is large relative to the income earned, the deductibility of such expenses is usually subject to close scrutiny by the IRD especially in the event of a tax audit.

The process of determining the deductibility of expenses can be divided into six distinct parts:

1. Outgoings and expenses

To ascertain if outgoings or expenses are deductible under IRO, the nature and circumstances leading to the expenses have to be examined. The label or name that the taxpayer or other parties put on them are irrelevant. The IRD would examine all available information to verify the true nature of the transactions.

2. To the Extent

Expenses should be apportioned if they are partly incurred for other purposes. Apportionment of expenses should be reasonable based on the facts of the case. Rule 2A to Rule 2C of the Inland Revenue Rules are some suggested methods for expenses apportionment. It is common under tax audit cases that the IRD suspected if expenses were overclaimed by taxpayer and apportionment of expenses is an ordinary solution to settle the issue.

3. Incurred during the basis period

Expenses incurred are not equal to expenses actually paid. Incurred is defined as what was paid or when the liability to pay arose. Therefore, if the amount is already due, it can be considered as incurred even taxpayer did not pay in that basis period.

4. In the production of chargeable profits

It could be interpreted as expenses that were incurred for enabling a person to carry on business and earn profits in the trade. This is one of the major parts that would be challenged by the IRD. Under tax audit cases, the IRD often rejects deductions claim as they cannot associate the nexus between the expenses incurred and actual earnings of the income.

5. For any period

The IRD allows any expenses that are incurred in the production of chargeable profits, regardless when the profits arise. It could be future profits or profits in prior years. For example, in *Texas Company (Australasia) Ltd v FCT [1940] 63 CLR 382*, taxpayer acquired goods and sold at a profit in a prior year, and it led to the occurrence of a foreign currency denominated trade debt. When the company settled the trade debt in the current year, exchange loss was incurred. The court allowed the deduction of exchange loss in the current year as it is incurred in the production of chargeable profits in a prior year.

6. Non-deductible expenses

Domestic or private expenses, penalties and fines are typical example of non-deductible expenses as they are not incurred in the production of chargeable profits.

On the other hand, capital expenditure(s) are non-deductible unless they are allowable under special provisions of the IRO. Whether the payment is revenue or capital in nature is one of the most common issues in tax audit cases. Generally, there are a few tests that can be used to determine the nature of the expenditure:

a) Once and For All/ Recurring Expenditure Test

Capital expenditure can be considered as spending once and for all but revenue expenditure is recurring every year.

b) Enduring Benefit Test

If the expenditure can (1) provide enduring benefit to a trade, (2) remove a capital liability or (3) improve an asset to make it more advantageous, it should be regarded as capital expenditure.

c) Fixed or circulating capital test

It depends on the nature of the trade or business. For example, desks and chairs are fixed assets in an accounting firm but they are circulating stock in a furniture retail shop.

d) Profit yielding structure test

If the expenditure is related to the structure within which profits are earned, it is regarded as capital in nature.

As the nature of expenditure is determined by factual information, taxpayer should get prepared for explanations on the intention and purpose of such expenditure with supporting documents.

Recommendations

If a company receives an enquiry from the IRD regarding the deductibility of expenses, the company should identify any risk areas and quantify related tax exposure. As the burden of proof is on the taxpayers, sufficient documentation is essential to substantiate the deduction claim. Apportionment of expenses might be appropriate to have a compromised settlement with the IRD. Apportionment should be in a reasonable basis and in accordance with the circumstances of the cases. It is highly recommended to consult professional advice if this subject matter is involved.

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