

## Tax alert

Departmental Interpretation and Practice Note No. 40 – the deductibility of prepayments

TAX

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The Inland Revenue Department (IRD) recently issued a revised version of Departmental Interpretation and Practice Note No. 40 (DIPN 40) clarifying which accounting standards are acceptable for the preparation of financial statements for a foreign company lodging profits tax returns in Hong Kong.

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### Background

DIPN 40 sets out the IRD's views on the tax treatment of prepaid or deferred revenue expenses (prepayments). The IRD's basic position is that the timing of a tax deduction for a prepaid expense should follow the accounting treatment for the expenses under the relevant financial reporting standards prescribed by the Hong Kong Institute of Certified Public Accountants.

### The revision

Paragraph 19 of the DIPN, which has been revised, makes it clear that, notwithstanding the IRD's position as outlined above, it recognises that the accounts of companies incorporated outside Hong Kong (and their branches), which carry on business in Hong Kong may be prepared on the basis of standards which vary from those in Hong Kong.

For such companies (and their branches), the IRD will generally accept the accounting treatment followed by the company in accordance with the relevant financial reporting standard of the "home" jurisdiction (or standards issued by the International Accounting Standards Board) to determine the timing of the deduction. The IRD does mention that although the financial reporting standards of the home jurisdiction may be accepted, the accounting profits or losses need to be adjusted in accordance with the provisions of the Inland Revenue Ordinance and established taxation principles. Accordingly, the IRD may look to apply an accrual concept for all prepayment deductions, in line with the way in which they are accounted for under International Accounting Standards, regardless of how such payments may be accounted for under the "home" jurisdiction's standards.