

Issued by: Tax Administration Jamaica (TAJ)

Issue Date: April 28, 2022

Advisory #: 032022/01/IT-TA

Technical Paper: **TAX IMPLICATIONS ADVANCED PAYMENTS/RECEIPTS**

TECHNICAL ADVISORY

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Abbreviations and Glossary of terms

Accruals Basis	An accounting method where revenue or expenses are recorded when a transaction occurs rather than when payment is received or made
Cash basis	The accounting method where revenue is reported on the income statement only when cash is received. Expenses are only recorded when cash is paid out
Earned Income	Revenue generated from the sale of goods, services rendered, or work performed.
GAAP	Generally Accepted Accounting Principles
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
ITA	Income Tax Act
Matching Concept	The accounting concept which states that the related revenues and expenses must be matched in the same period.
Operating Lease	An operating lease is a contract that permits the use of an asset without transferring the ownership rights of the said asset. (https://www.investopedia.com/terms/o/operatinglease)
Rent	Reference to rent in this document is also a reference to operating lease
Trade Receipts	A trading receipt is essentially a sum derived by the trader from a trade carried on by him
TAJ	Tax Administration Jamaica
The Authority	Tax Administration Jamaica
Year of Assessment	Section 2 of the ITA defines "year of assessment" as the period of twelve months commencing on the first day of January in each year.

Purpose

This advisory has been published as part of the mandate of TAJ to simplify the administration of the ITA and promote ease of compliance. It aims to inform both internal and external stakeholders of The Authority's position on the general treatment for income tax purposes of certain incomes received in advance; especially, advanced rent. It will therefore provide guidance on how lease payments made in advance should be treated for income tax purposes.

This Advisory will also:

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- (i) Clarify the concept of “*earned income*” and “*income arising or accruing to a person*” and will specifically address TAJ’s policy on the accepted income tax treatment for advanced rent.
- (ii) Explain how The Authority arrived at its position by discussing relevant:
 - Judicial precedents (Case Law)
 - International Accounting Standards and
 - Provisions of The Income Tax Act
- (iii) Specify how the transaction should be treated in the financial statements of the parties to the agreement.

Legislation

- The Income Tax Act

Judicial Precedent

- Case Laws
 - Commissioner Inland Revenue v Falkirk Ice Rink Limited 51TC 42
 - John & E Sturge Ltd V Hessel (Inspector of Taxes)
 - Whitworth Park Coal Co Ltd and Others IRC (1961) A.C 31
 - Board of Inland Revenue vs Winston Herbert Edward Suite
 - Heasman v Gordon [1954] Ch.744

Accounting Principles

- GAAP
- IAS
- IFRS

Other References

Article on accounting and taxation of short term leases and lease for low value assets
<https://www.grantthornton.com.ph/insights/articles-and-updates1/lets-talk-tax/accounting-and-taxation-of-short-term-leases-and-lease-for-low-value-assets>.

Background

The terms of a fifteen (15) year lease agreement stipulated that the 15th year rent was to be paid upon possession of the leased premises. The Authority was called upon to determine

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which of two (2) proposed accounting treatments should be adopted when a payment is being made in respect of a future period.

Proposed treatments for consideration:

1. Rental (income, profits or gains) should be recognized and taxed as income in the year of assessment in which it is received.
2. Rental (income, profits or gains) should be recognized when earned and therefore taxed in that year of assessment. For example, in the case of the aforementioned lease agreement, in the fifteenth year of occupying the leased premises. This treatment is in accordance with the provisions of section 5 of the ITA which states that income tax shall be payable for each year of assessment in respect of all income, profits or gains arising or accruing in that year of assessment.

Advanced receipts are amounts received before the goods or services to which they relate are delivered or rendered, respectively. Advanced receipts of any kind broadly include any amount received in money or kind or even services, in exchange for the provision in some future period of money or other services. It also includes those situations where money is received and there is a promise to return it or a portion of it.

The ITA is silent on exactly when advanced income received should be taxed. Generally, a taxpayer that receives an advance payment should include it as taxable income when it is received.

Issue

The issues for consideration are therefore:

- i. At what point should expenses paid in advance be subject to income tax?
- ii. When should a person be assessed for income tax on income received?
 - Is it in the year that the income is received? Or
 -
 - Is it in the year when the income is earned?
 -

These questions will be answered by perusing the relevant provisions of the Income Tax Act, case law, pertinent accounting standards and generally accepted accounting principles.

Income Tax Act Provisions

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Section 5 brings to charge:

- (a) the annual profits or gains **arising or accruing**-*
 - (i) to any person residing in the Island from any kind of property whatever, whether situated in the Island or elsewhere; and*
 - (ii) to any person residing in the Island from any trade, business, profession, employment or vocation whether carried on in the Island or elsewhere;*
 - (iii) to any person, whether a Commonwealth citizen or not, although not resident in the Island, from any property whatever in the Island, or from any trade, business, profession, employment or vocation exercised within the Island, or from the provision to any person residing in the Island of industrial or commercial information or advice, or management or technical services, or similar services or facilities, or plant or equipment on hire (otherwise than under a bona fide hire--purchase agreement as defined in subsection (1) of section 2 of The Hire-Purchase Act); and*
 - (iv) to any business organization that has a permanent establishment in Jamaica; and*
- (b) profits or gains accruing in or derived from the Island or elsewhere, and whether received in the Island or not in respect of-*
 - (i) dividends (other than those falling within exception (b) of paragraph (1) of the table contained in section 34), discounts, interests, (including interest referred to in section 31A), annuities, pensions or other annual sums;*
 - (ii) rents, royalties, premiums and any other profits arising from property;*

Case Laws:

I. Commissioner Inland Revenue v Falkirk Ice Rink Limited 51TC 42

This case considered whether a payment received as a gift to supplement trading receipts and enable branch trade to continue, constitutes a trade receipt accruing or arising from the trade and therefore subject to tax. The Curling Club which rented the rink donated \$1500 to the Company. It was ruled that the payment was made in order that it might be used by the company in its business and that in substance and form it was a payment made to a trading company artificially to supplement its trading revenue from Curling. So that, in the interest of The Curling Club and its members, the trading company would be able to continue to provide Curling with facilities in the future. The payment was therefore of a business nature and is accordingly a trade receipt.

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Definitions of “Trade Receipts” considered during the case:

- a. *A trading receipt is essentially a sum derived by the trader from a trade carried on by him, whether in the UK or elsewhere.*
- b. *The proper approach is to first consider the nature of the receipt; secondly, the taxpayer’s activities; and thirdly, the purpose for which the payment was made. If it was made with an intent that a benefit should accrue to the payer from the assistance it gave to the carrying on of the trade; then the fact that the trade being carried on is of interest to the payer, makes it easier to find that the payment is a trade receipt in the hands of the recipient.*
- c. *The phrase “trade receipts” is not one which has a statutory definition, but it implies that there is a trader carrying on a trade or profession and that the payment is received in the course of his trade or profession.*

II. ***John & E Sturge Ltd V Hessel (Inspector of Taxes)***

Consideration was received in the form of shares. This was made in exchange for the litigant imparting its citric acid preparation know-how to another company.

It was held that the shares allotment in exchange for the imparting of the know-how should be treated as receipts of the trade for the purpose of income tax because those shares would have been acquired otherwise than in association with the disposal of a capital asset by the company.

In the notes to the Held position that the appeal would be dismissed, point (iii) *stated*: “The accounting year to which the consideration received by Sturge was to be attributed, depended on when the consideration was earned. The first three installments of money to come were not receivables under the first agreement unless and until Sturge had fulfilled its obligation under the second agreement.

III. ***Whitworth Park Coal Co Ltd and Others IRC (1961) A.C 31.***

Principle - Income arising in the year of receipt and not as income for the period in which it was expressed to be paid.

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IV. ***Board of Inland Revenue v Winston Herbert Edward Suite 1986.***

Interdiction pay was received some years later.

Principle – Tax is payable when the income is received.

‘However, on that very point we refer to Lord Wilberforce in WT Ramsay Ltd who said that

“there may indeed and should be considered the context and scheme of the relevant Act as a whole and its purpose may, indeed should, be regarded”.

This argument is relevant in the present case, as the circumstances did not allow for the income to be taxed when earned which is what is provided for in the taxing statute of the country to which this case originated.’

In the ***Board of Inland Revenue v Winston Herbert Edward Suite PC 49 1984***. The Privy Council considered whether a teacher that was interdicted and then acquitted should have the half salary that was owed to him assessed for income tax in the year that he received payment following his acquittal. The taxpayer having received during 1976 emoluments for each of the years 1970 to 1975 became liable to be assessed to income tax on the appropriate emoluments in respect of each of the years 1970 to 1975 but not in respect of the year 1976.

“The appellant Board of Inland Revenue assessed the respondent to income tax on the footing that the sum of \$35,803.92 formed part of his income for 1976”, the year of his acquittal. The Respondent contended that he should only have been assessed after his acquittal for each of the years 1970 to 1975 in respect of the half salary withheld from him.

Accordingly, the Tax Appeal Board and the Court of Appeal found in favour of the taxpayer/respondent. In which case, the respondent should have been assessed for each of the years 1970 to 1975. Their Lordships therefore dismissed the appeal.

It is however instructive to note that the proviso in Section 78(2) of our Income Tax Act specifies that emoluments should be taxed in the year it is received as income irrespective of the year in which it was earned.

V. ***Heasman v Jordon [1954] Ch.744***

The case discussed among other matters the definition of the term **“for the year of assessment”** which was not sufficiently described in the Income Tax Act. Roxburgh J in this case defined *“for the year of assessment” as the income earned “in respect of services rendered during the year of assessment”*.

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The Privy Council dismissed the appeal of the Board of Inland Revenue following the examination of similar cases such as **Whitworth Park Coal Co. Ltd and others v IRC [1961]** and the Income Tax legislation in Trinidad.

The reasoning seemed to be that while income may be taxed when received, the tax applied should be in respect of the years in which the income was earned and the services rendered.

GAAP Revenue Recognition Principles

GAAP requires that revenues are recognized according to the revenue recognition principle, a feature of accrual accounting. This means that revenue is recognized on the income statement in the period when realized and earned—not necessarily when cash is received.

Concern must be given to the “*accrual*” principle and the “*matching*” principle. The accrual principle of accounting is the idea that all transactions should be included in the periods during which they actually take place, rather than when cash flow is associated with them. This principle is particularly important in accrual accounting and allows for the production of clearer financial statements that show what actually happened during the period.

“*Matching*” refers to the principle of associating a particular income item with the costs the taxpayer incurs in order to earn it. Under the matching principle, all expenses will be recorded with their related revenue. Frequently, amounts received in a prior period that will not be earned until a future period will not result in the taxpayer's incurring of associated expenditures until the future period either.

Under GAAP, it typically is inappropriate to treat such a receipt as income until the associated expenses have been incurred or at least accounted for. While this rule makes sense from a financial accounting perspective, the values that underlie the accounting treatment do not necessarily support treatment for tax purposes.

The Financial Accounting Standards Board (FASB) which sets the standards for U.S. GAAP has the following five (5) principles for recognizing revenue:

1. Identify the customer contract
2. **Identify the obligations in the customer contract**
3. Determine the transaction price
4. **Allocate the transaction price according to the performance obligations in the contract**
5. Recognize revenue when the performance obligations are met

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International Accounting Standards

IAS 17.50

Lease income from an operating lease should be recognized over the lease term on a straight-line basis, unless another systematic basis is more representative of the time pattern in which use benefit is derived from the lease asset is diminished.

International Financial Reporting Standards

IFRS 15

The five-step model applies to revenue earned from a contract with a customer with limited exceptions, regardless of the type of revenue transaction or the industry.

Step one: Identification of contract

Step one in the five-step model requires the identification of the contract with the customer.

Step two: Performance obligations

Step two requires the identification of the separate performance obligations in the contract. This is often referred to as 'unbundling', and is done at the beginning of a contract. The key factor in identifying a separate performance obligation is the distinctiveness of the good or service, or a bundle of goods or services.

Step three: Transaction price

Step three requires the entity to determine the transaction price, which is the amount of consideration that an entity expects to be entitled to in exchange for the promised goods or services.

Step four: Allocation of price to performance obligations

Step four requires the allocation of the transaction price to the separate performance obligations.

Step five: Recognition of revenue

Step five requires revenue to be recognised as each performance obligation is satisfied. An entity satisfies a performance obligation by transferring control of a promised good or service to the customer, which could occur over time or at a point in time.

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Analysis

Review of the Case Laws:

An analysis of the relevant case laws, indicate judicial precedence for applying the accruals basis, the matching concept and the income recognition guidelines except where the relevant legislative provision expressly states an alternative treatment.

Therefore, the appropriate statutory provision(s) were also examined in the respective jurisdiction where the case arose because these matters could not have been decided without reference to the legislative framework.

There is no dispute that an advance payment in respect of a service or lease/rental agreement (such as rent in respect of the fifteenth year) would qualify as trade receipts. However, the question that needs to be answered is, when was the income earned?

In the ***Whitworth Park Coal Case***, the precedence was set for making income earned in a particular year of assessment, subject to tax in the year that it is received. Notwithstanding the decision of the House of Lords in that case which concerned Schedule D payments (profits of trades, professions or vocations); it does not affect the principle that gains and profits from an employment for a year of assessment or for a year of income, means gains or profits in respect of services rendered during that year.

However, on the other hand in the ***John E Sturge Limited Case***, the determination did not stop at the share allotment being confirmed as trade receipt. The focus should therefore be on case laws which consider the timing of receipts and expenditure, having established the source as being from trading activities.

The ***Winston Herbert Edward Suite case*** strongly supported the argument that income can only be taxed when earned. In this case, the decision was based on the provision in the statute which states that tax shall be charged for each year of income upon the chargeable income of any person for that year, although based on the circumstances of the case the income was and could not be taxed until when received.

Review of the ITA:

It must be pointed out that whereas the provision uses the word “gains” in relation to income, the Income Tax Act’s charging and exemption provisions, do not mention “inheritance” nor make references to the term “capital gains”; yet, it is accepted that income/gains from these sources are not subject to tax (the transactions falling within the scope of section 5.7 being the exception). It is instructive to note that the words used in the charging provision are annual profits or gains, suggesting that a form of trade has to be established and therefore

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subject to the source doctrine which places reliance on the badges of trade to classify sources as “trade receipts”.

Section 5 of the ITA has settled the question of whether an advanced payment of rent should be subject to Income Tax. Since an advanced payment of rent can be seen as an “income, profits or gain” it is subject to income tax at some point. However, the real issue is, when should this advance payment of income be taxed for income tax purposes. The prefatory words in Section 5 state “Income Tax is payable by every person at the rate or rates specified hereafter for each year of assessment”.

The Act does not offer definitions for arising or accruing, therefore we explored the ordinary business and legal definitions for the terms.

Arise - “to start to exist”

<https://www.oxfordlearnersdictionaries.com/definition/english/arise>

- “To come into existence” (Oxford Student Dictionary)

Arising – “become apparent”

Accruing – “make provision for (a charge) at the end of a financial period for **work that has been done** but not yet invoiced”. (www.dictionary.com)

- “to gain or build up payments or benefits” (Oxford Student Dictionary)

- “To come into existence or mature as an **enforceable claim or right**. For example, a cause of action may be sued upon once it is an enforceable claim”. (Law Dictionary)

- “To come into existence as a legally enforceable claim” (Merriam-Webster)
○ “Income which has **been earned** but has yet to be received”. (Investopedia.com)

○ “Accrued income is income which has been earned but not yet received”.

- **Income must be recorded in the accounting period in which it is earned.**

“Therefore, accrued income must be recognized in the accounting period in which it arises rather than in the subsequent period in which it will be received”. (www.accountingsimplified.com) *Review of the Accounting Principles*

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The Income Tax Act focuses on the gains arising or accruing in the year of assessment. However, this does not necessarily mean that the income must be received for it to be chargeable to tax. Therefore, for the taxpayer to have income arising or accruing to him, it must be “earned” or the taxpayer having received monies for goods or services supplied by him, must have a legitimate claim to keep the monies received.

Review of indications and Implications of Accounting Principles:

The accounting principles (GAAP) and International accounting standards promote consistency and efficiency globally and give persons “*a common financial language and understanding*”¹ that is widely recognised. The principle established by these bodies is instructive, specifically in the context of the issues concerning advance rent/lease.

The international accounting standards by and large support the accruals basis of accounting where income is recognized when earned rather than when payment is received. The five step model advanced by IFRS 15 is helpful in forming a basis for the position “*of recognizing revenues to depict the transfer of promised goods or services to the customer in an amount that reflects the consideration*”. In other words, the core principle of IFRS 15 is that revenue is recognised when the goods or services are transferred to the customer, at the transaction price. The illustrative 5 step rule provides a firm foundation for revenue recognition and the matching concept in accounting which extends to advance receipts.

The methods of accounting embraced by these international accounting standards is complemented by the legal precedence outlined above which is helpful in making a determination in the instant case as to when rent that is received in advance is to be assessed and taxed.

TAJ’s Position

It is relevant for the purposes of tax administration, to determine whether someone in receipt of advance income has earned economic income from the time of receipt. Having also reviewed the legal precedents, our position is that both principles are generally accepted with regards to how income received should be treated. i.e. advanced payments should be taxed for income tax purposes when received or advanced payments should be taxed when earned and not when received. The circumstances of the payment, type of payment and the time when goods are provided or services rendered will determine which principle applies.

1. Judicial instruction abstracted from “**Bennion on Statute**” fifth edition is that taxing statutes are to be interpreted by applying the purposive rule of statutory interpretation. The purpose of the particular provision of the Income Tax Act should therefore be contemplated when interpreting each sections of the Act.

¹ <https://bizfluent.com/info-7975847-benefits-international-accounting-standards.html>

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2. The principles derived from the appropriate case laws are that:
- a. The advanced receipts of rent (as described in the back ground section of this advisory) is “trade receipts”.
 - b. Income earned as a result of trading activities normally referred to as “trade receipts” are subject to income tax.
 - c. Income may be taxable when it is received where income is received and earned at the same time.

As indicated above, the ITA is silent as to exactly when advanced income received should be taxed. Notwithstanding the fact that through this advisory, TAJ advances a general approach to taxing the advanced payment of income, this approach may be varied depending on the facts and circumstances of the particular case.

Once it has been established that the receipt is trade income, there are two questions that need to be addressed:

1. How is section 5 of the Income Tax Act to be interpreted regarding the advanced payment of income and
2. Whether the monies paid upon possession for a year other than the current year is to be taxed on receipt

The definition of the term “*for the year of assessment*”, the meaning of which has not been sufficiently described in the Income Tax Act. Roxburgh J in the case *Heasman v Gordon* defined “for the year of assessment” as income “in respect of services rendered during the year of assessment “. If this definition is applied in the circumstances where an advanced payment of rent is concerned, the fifteenth year payment paid in year one of the lease could not be assessed in year one because no service had been rendered by the lessor in respect of the payment received and the lessee would not have occupied for the fifteenth year.

The reasoning from the tax cases convey that while income may be taxed when received, the tax applied should be in respect of the years in which the income was earned and the services rendered.

The guidance that the IAS and the IFRS offers as it concerns the recognition of income from operating leases, is helpful and is relevant based on the character of lease and service agreements. As it concerns the treatment of credit sales, it is recognized that recording advanced income on the cash basis does not support the reporting of credit sales. The accruals approach treats with both cash and credit sales, so it is the most inclusive approach that allows for the taxing of income.

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Case law supports the accruals basis of recording income and expenditure. The case of ***Heasman V Gordon*** was important in proffering a more meaningful definition of “for each year of assessment” than did section 2 of our Income Tax Act.

It is important to note is that income can be taxed when received in situations where income is received and earned at the same time. In the case where the payment is not in respect of the current year but rather in respect of some future period (say 15th year) that approach cannot be sustained since the sum would be paid in advance of it being earned. For income tax purposes, one should ascertain when income paid in advance is earned, as it is at that time that it becomes taxable. Income paid in advance is not conclusive evidence that it has been earned and for income tax purposes TAJ is prepared to entertain that broader view when determining the treatment of advanced income paid.

The Accounting treatment and effect of the transaction on Financial Statements of the parties to the Agreement

- **The payer**

The advanced payment, not being in respect of a current year’s operating expense must not impact the Profit and Loss Account in the year that it is made, but instead should remain on the Balance Sheet until it can be applied to a current year’s operating expense.

- **The recipient**

Likewise, the advance payment although received, must not be credited as income in the Profit and Loss Account but should remain on the Balance Sheet as a short term liability until it is earned.

Conclusion

On the basis of the foregoing, it is our position that where the statute gives guidance on the basis on which the income should be taxed, then that should be the overriding principle enunciated. A relevant legislative provision in the Income Tax Act will not be overruled by the circumstances described in the **Board of Inland Revenue v Winston Herbert Edward Suite 1986**. In the instant case, the income could only have been taxed when received, but it was not to be taxed as income belonging to the year it was received. It is important to note that, unlike Jamaica, the jurisdiction of the case law had no legal framework or provisions that prescribed a specific treatment for retroactive payments of emoluments.

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Therefore, in circumstances where the terms of an agreement stipulates that an advance payment is to be made in addition to the current year expense, that advance payment (income, profits or gains) being received upfront is to be recognized by the recipient when earned and taxed in that year of assessment in which it is earned in accordance with the provisions of section 5 of the ITA which provides that income tax shall be payable for **each year of assessment** in respect of all income, profits or gains arising or accruing.

Notwithstanding the fact that the ITA does not specially address the issue, TAJ is confident in placing reliance on the provisions of section 5 of the ITA which provides that income tax shall be payable for **each year of assessment** in respect of all income, profits or gains arising or accruing. Therefore, notwithstanding that the profits and gains may be received in a particular year of assessment, the income should only be taxed when earned.

Where the legislation is silent and TAJ does not issue an instructive Technical Advisory or Practice Note the method prescribed by the appropriate International Financial Reporting Standard (IFRS) is to be adopted.
