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Tax alert

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Secan Ltd no longer authority to tax unrealised gains on securities marked to market?

The Court of First Instance has, in *Nice Cheer Investment Ltd v CIR* [2011] HCIA 8/2007, held that a taxpayer's unrealised gains arising from the mark-to-market revaluation of securities held at balance sheet date, which were credited to its profit and loss account in accordance with ordinary accounting principles, were not chargeable to profits tax.

Background

The taxpayer's principal activity was investment trading in Hong Kong listed securities. In the preparation of its accounts, the taxpayer adopted ordinary commercial accounting principles (namely SSAP 24 and HKAS 39) to value its trading investments. In computing its adjusted losses or assessable profits, the taxpayer excluded the unrealised gains from assessment, but claimed a deduction for the unrealised losses on trading investments/securities at year end. There was no dispute that the taxpayer's accounts for the various financial years were prepared in accordance with the then prevailing accounting practice. Where there were no trading activities, the profits or losses merely reflected the changes in fair value of the trading stock, rather than profits made from a trading of the trading stock, as there had not been any disposal.

Issues before the Court and the Commissioner and taxpayer's positions

The central question for the Court was whether the taxpayer should be chargeable to profits tax on unrealised mark-to-market revaluation gains, where they arose on Hong Kong listed securities held as trading investments, and were credited to the profit and loss account in accordance with ordinary principles of commercial accounting. The Court considered the below issues, which were raised during the appeal:

1. What is the meaning of the terms 'profits' and 'assessable profits' under section 14(1)
2. Whether what the Taxpayer did was within the intendment of the charging section.

The Commissioner based his case squarely on *CIR v Secan Ltd. & Ranon Ltd. 5 HKTC 266* and contended that under the statutory regime, profits and losses must be ascertained in accordance with ordinary principles of commercial accounting, as modified to conform to the Inland Revenue Ordinance (IRO). He asserted that this was not a case of charging profits tax on notional profits or anticipated profits as the taxpayer's financial statements were properly drawn up in accordance with the prevailing accounting standards, and reflected the unrealised gains arising from revaluation of the listed securities.

The taxpayer argued that unrealised gains arising through revaluation were not chargeable under section 14(1) of the IRO because the word 'profits' means real profits and not notional profits. He asserted that it is an overriding principle of tax law that profits can only be taxed when in fact they have been earned, realised, ascertained, arisen and derived and cannot be anticipated, and that SSAP 24 and HKAS 39 cannot have the effect of changing the meaning and scope of the word 'profits' in section 14(1).

The decision

The Court held that on their true and proper construction, the terms 'profits' and 'assessable profits' mean real profits arising out of actual trading, professional or business activities, between the taxpayer and another party, in Hong Kong. In the case of a taxpayer carrying on a trade, the trading activity means the buying or selling of commodities, including listed securities, or the provision of services in a commercial transaction for reward. The profits to be chargeable to profits tax must be real profits, in the sense that they have been earned, ascertained or accrued, regardless of whether they have been received in cash; but do not include book or notional profits arising on a revaluation of trading stock.

There was no dispute that all the taxpayer did was hold the listed securities and draw up its financial statements in accordance with the prevailing accounting practice. The taxpayer contended that it had done nothing to bring itself within the intendment of section 14(1). It made no trading transactions from which the unrealised profits arose and it could not trade with itself. On the facts, not only was there no trading between the taxpayer and a third party, there was no exchange, not even a simple transfer by the taxpayer of the listed securities from itself in one capacity to itself in another, or to its shareholders, directors or employees, or a sale of them at undervalue. There was a total lack of commercial activity. The unrealised profits recognised by SSAP 24 and HKAS 39 are not chargeable to profits tax under the Ordinance.

The Court emphasised that, while accounting principles may provide the proper basis for quantifying assessable profits, the calculation of such profits in accordance with accounting principles is subject to the provisions of the tax statute (in Hong Kong, the IRO) and judge made rules interpreting that statute. The Court quoted from Lord Reid in the decisions in *Duple Motor Bodies v Ostime [1961] 39 TC 537*, *B.S.C. Footwear Ltd and Ridgway (Inspector of Taxes)* [1972] AC 544:

"The application of the principles of commercial accounting is, however, subject to one well-established though non-statutory principle. Neither profit nor loss may be anticipated."

Further, as explained by Lord Salmon in *Willingale v International Commercial Bank Ltd* [1978] AC 834, this does not mean until the profit has been received in cash, but means until it has been accrued, ascertained or earned.

The Court also held that there was no unfairness in allowing a taxpayer to claim unrealised losses and not to pay profits tax on unrealised profits noting that the Commissioner accepts as a prudent practice, following *B.S.C. Footwear Ltd*, for stock in trade other than financial instruments to be valued at cost or market value whichever the lower.

Under DIPN No. 1 (Revised), the Commissioner permits small and medium-sized entities to value their financial stock at cost instead of having to adopt HKAS 39 in their financial reporting requirements. This concession is not statutory. The Commissioner is, in effect, charging profits tax on anticipated profits on one class of taxpayer and exempting the same from other classes of taxpayers. The Court noted that whilst there is no equity in a tax statute, a tax regime should not be applied so arbitrarily as to create such inconsistent results.

The Court also held that as the UK case of *Sharkey v Wernher [1955] 36 TC 275* was decided on the basis of a very different tax regime, it was inapplicable to Hong Kong and should cease to be quoted as authority for the proposition that a man can trade with himself.

Comment

This decision will be welcomed by taxpayers and practitioners alike. However, the decision is clearly contrary to the IRD's policy that unrealised profits recognised in the accounts under ordinary principles of commercial accounting are subject to tax. Inevitably, we expect the Commissioner to appeal the decision and the final outcome of the case will be awaited with keen interest.

A number of key distinctions are made by the Court, which, if upheld by the higher courts, will go some way to clearing up some of the confusion created in the Hong Kong tax community in the wake of the decision of the Court of Final Appeal in *Secan*, 11 years ago.

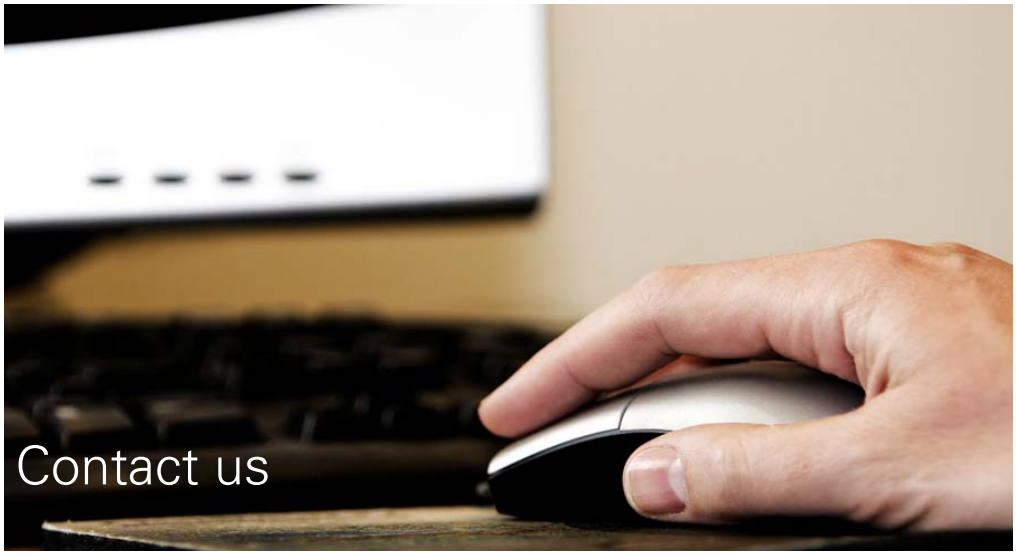
Judge Anthony To makes a distinction between the calculation of profits, a matter which the precedent from the UK (followed in Hong Kong) has left to the professional accountant, and the determination as to which profits should be assessable to profits tax. He then goes on to note that the *Secan* case simply confirmed this first point, determining that as the relevant accounting standards allowed for two treatments in determining the profits of the taxpayer in that case, and insofar as the taxpayer had selected to use one of these treatments in its accounts and for the purposes of its calculation of assessable profits, the courts could not later overturn the determination of profits by substituting a court-made definition of profits. However, he stressed that this was only the case as the profits in question were real i.e. the second question, as to which profits should be subject to tax, did not arise, as the accounting profits in *Secan* did not contain any notional gains, which would need to be excluded from assessable profits. By contrast, this second question was the focus of the Nice Cheer Investment case.

This distinction is in line with the understanding, that evolved in the UK on the basis of such precedent setting cases as *Gallagher v Jones [1994] Ch 107* (to which Judge To makes repeated reference), the respect for accounting principles in determining 'profits' did not displace the tax principles used to determine 'assessable profits', such as the non-anticipation of profits, which emerge from the proper legal construction of tax statutes. In the UK, this conclusion necessitated the introduction of specific statutory provisions, subjecting notional gains to tax, to give tax effect to the fair value movements recognised in the income statement under IAS 39. Judge To reasons that the Hong Kong basis for the non-anticipation of profits tax principle can be found in the proper construction of the expression *'profits arising..from..trade'* in section 14, arguing that this necessitates some exchange with a third party, and that a taxpayer, cannot enter into any trading exchange with itself.

The comments in relation to the principle in *Sharkey v Wernher* are also of interest, although insofar as the taxpayer did nothing with the securities in the course of the year, not even transferring them from itself in one capacity to itself in another, or to its shareholders, directors or employees, or selling them at undervalue, the comments are likely obiter dicta. The Courts and Board of Review in Hong Kong have, over the years, blown hot and cold over *Sharkey v Wernher* and other UK decisions based on Sharkey, concerning transfers between related parties at an undervalue, such as *Petrotim Securities Ltd v Ayres 41 TC 389* and *Ridge Securities Ltd v CIR 44 TC 373*. In this regard, the most notable opposition to the Sharkey principle was expressed in the case of *CIR v Quitsubdue Ltd [1999] 2 HKLRD 481*. Judge To considers that, as the *Sharkey and Wernher* principle involved a transfer of stock between two different trades (horses transferred from the stud farm to the racing stables), and insofar as Hong Kong profits tax does not require the separate calculation of profits for each trade (but, unlike the UK, assesses all profits collectively) the case should be viewed as having been based on a distinguishable statute and should not be considered proper precedent in Hong Kong.

Interestingly, Judge To accepted that unrealised losses may be recognised for tax purposes, arguing that while section 14 of the IRO requires that profits must be *'arising..from..trade'* and therefore, can only be assessable if they arise from some exchange, losses are not so qualified and can be recognised even without realisation through exchange. Some may question whether this contention can be so strongly supported.

Given the fundamental nature of the issues raised in this case to the operation of Hong Kong profits tax, the progress of this case through the Hong Kong courts is likely to be closely monitored.



Contact us

For more information, please contact:

Corporate Tax, KPMG China

Khoon Ming Ho
Partner in Charge, Tax
China and Hong Kong SAR
Tel: +86 (10) 8508 7082
khoonming.ho@kpmg.com

Vaughn Barber
Partner
Tel: +852 2826 7130
vaughn.barber@kpmg.com

Charles Kinsley
Principal
Tel: +852 2826 8070
charles.kinsley@kpmg.com

Jennifer Wong
Partner
Tel: +852 2978 8288
jennifer.wong@kpmg.com

Ayesha M. Lau
Partner in Charge, Tax – Hong Kong SAR
Tel: +852 2826 7165
ayesha.lau@kpmg.com

Darren Bowdern
Partner
Tel: +852 2826 7166
darren.bowdern@kpmg.com

Curtis Ng
Partner
Tel: +852 2143 8709
curtis.ng@kpmg.com

Garry Laird
Senior Tax Advisor
Tel: +852 2143 8795
garry.laird@kpmg.com

Chris Abbiss
Partner
Tel: +852 2826 7226
chris.abbiss@kpmg.com

Nigel Hobler
Partner
Tel: +852 2143 8784
nigel.hobler@kpmg.com

John Timpany
Partner
Tel: +852 2143 8790
john.timpany@kpmg.com

kpmg.com/cn