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Tax alert

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Court of Appeal upholds decision of the Court of First Instance that unrealised gains are not chargeable to profits tax

In a decision, which will be welcomed by taxpayers and practitioners alike, the Commissioner of Inland Revenue has failed to convince the Court of Appeal that unrealised gains on securities held for trading purposes are chargeable to profits tax.

Background

The Court of Appeal (CA) handed down its decision in the case of Nice Cheer Investment Limited v CIR on 19 June 2012 (CACV 135-2011) - see Tax alert Issue 15 – July 2011.

In brief, the taxpayer recorded net unrealised gains in its profit and loss account in respect of trading securities held at year end. The unrealised gains were based on the changes in the fair value (i.e. quoted market price) of the trading securities held at year end. In computing the company's assessable profits, the taxpayer treated the unrealised gains as non-taxable, whilst claiming a deduction for the unrealised losses. The Inland Revenue Department (IRD) argued that the unrealised gains were taxable in the year they were recognised in the profit and loss account.

The decision

On appeal to the CA, the court considered the question of whether the unrealised gains were profits chargeable to profits tax. In the court's view, this was entirely a matter of statutory interpretation, and not something that would be determined by accounting standards.

The CA noted "the fact that the financial statement should reflect the fluctuation in the fair value of these trading … securities … did not mean that unrealised gains are 'profits' for the purpose of the IRO (Inland Revenue Ordinance). There is clearly a difference between what is required by way of accounting standards in a financial statement so that a full picture may be presented on the financial position of the company and what is (a) profit for the purpose of profits tax under the IRO."

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Moreover, viewed in the statutory context, the CA noted that "it is seriously wrong that the unrealised trading gains disclosed in the profit and loss account, which enable users to have a fuller picture of the economic performance of a company, will be regarded as profits for the purpose of section 14. This approach is wrong as there is no receipt arising in or derived from the trade in respect of that investment. To tax the unrealised gains offends the principle that profit must be realised and not anticipated."

During the hearing, it was accepted by the Commissioner that "the taxpayer will be taxed on unrealised gains which may never materialise if the taxpayer sold the investments in the next year at a loss. Further, the taxpayer could not carry forward the loss if he ceased trading in the next year. This highlighted the hardship faced by the taxpayer."

On the question of unrealised losses, the CA noted "the consequence of the cost or lower market value rule is that losses are relieved when stock falls in value. The loss is an aspect of the cost of an asset, which is actually incurred by the act of purchase whereas a profit is earned by an act of disposition, which has not happened at all in this case. So far as profits are concerned, the consequence of the rule is that, as stock is never brought in at more than market value, gains are not recognised as stock increases in value."

Comment

The CA decision is clear and unambiguous in the view that unrealised gains from trading investments held at year end are not taxable. Such gains are not realised profits taxable under the IRO.

Although the accounting treatment may play a role in determining when profits may be taxable, their importance should not be over-emphasised. The assessability of profits recognised in the financial statements must be calculated in accordance with the statutory provisions of the IRO. *CIR v Secan Ltd.,* which was central to the Commissioner's appeal as to when a profit is taxable under the IRO, was not authority for the proposition that a profit is taxable simply because it is recorded in the accounts.

The CA decision is well reasoned by reference to a long line of precedent cases and in our view, is unlikely to be overturned on appeal. On the basis that the decision stands, it is hoped that the IRD will critically examine its approach to the treatment of unrealised gains and more generally re-examine the interaction between accounting and tax profits.

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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

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

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

Alice Leung
Partner
Tel: +852 2143 8711
alice.leung@kpmg.com

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

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

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

kpmg.com/cn

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