HONG KONG TAX ALERT

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Court of Final Appeal confirms that unrealised revaluation gains are not taxable

In *Nice Cheer Investment Limited v CIR*, FACV 23/2012, the Commissioner of Inland Revenue (the Commissioner) lost his appeal to the Court of Final Appeal, whereby the Court found that unrealised gains recognised at year-end are not taxable. The Court clearly found that unrealised profits are not chargeable to tax, notwithstanding that they have been recognised in the taxpayer's financial statements in accordance with international accounting standards.

Background

The principal business of Nice Cheer Investment Limited (the Company) consisted of trading in marketable securities quoted in Hong Kong. Prior to the introduction of new accounting standards in 1999 and subsequent years, its trading stock was, in accordance with the conventional practice, shown in its financial statements at the lower of cost and net realisable value. This had the effect that unrealised increases in the value of its trading stock during the accounting period were not reflected in its profit and loss accounts or tax computations. Following the introduction of new accounting standards in 1998, the Company recorded in its profit and loss accounts not only profits and losses which it had realised by the sale or disposal of trading stock during the accounting period, but also changes in the value of unrealised trading stock held at the end of the period.

For tax purposes, the Company claimed that the unrealised gains were not taxable, whilst unrealised losses were deductible. On behalf of the Commissioner, it was argued that the unrealised gains and losses arising from revaluation of trading stock held at year-end were taxable and deductible respectively in the year in which they were recognised.

The Court of First Instance allowed the Company's appeal and that decision has now been affirmed by both the Court of Appeal and the Court of Final Appeal.

Question

Whether, for the purpose of profits tax, unrealised increases in the value of trading stock held at the end of the accounting period as a result of revaluation should be included in the computation of *"the full amount of the profits … arising in or derived from Hong Kong during the year[s] of assessment..*

This question raises a matter of statutory construction, not accounting practice. The question is one of law: what does the statute mean by the words *"the full amount of the profits there from during the year of assessment"*?

The Commissioner's case

The Commissioner relied on three propositions. First, the word 'profits' is not defined in the Inland Revenue Ordinance (the Ordinance), and in the natural and ordinary meaning of the word, unrealised profits are nonetheless profits. Secondly, the amount of profits during a year of assessment is primarily a question of fact. Thirdly, the amount of any profits or losses during the year of assessment must be ascertained by reference to ordinary principles of commercial accounting, unless these are contrary to an express statutory provision in the Ordinance.

Decision of the Court of Final Appeal

The decision found on the meaning of 'profits' within the meaning of the Ordinance. In the judgement, Lord Millett noted that *"There are two cardinal principles of tax law: (i) the word 'profits' connotes actual or realised and not potential or anticipated profits; and (ii) neither profits nor losses may be anticipated. The two principles overlap and are often interchangeable, for they both involve questions of timing; but they are not identical. The first is concerned with the subject-matter of the tax, uses the word 'anticipated' in its secondary meaning of 'expected' or 'hoped for', and excludes profits which have not been and may never be realised. The second is concerned with the allocation of profits to the correct accounting period, uses the word 'anticipated' in its primary meaning of 'brought forward', and prevents profits being taxed prematurely."*

Lord Millett also noted that it must be borne in mind that the accountancy standards are directed to the preparation of financial statements and not tax computations, and they serve different purposes. Financial statements are prepared in order to give readers a true and fair view of the state of affairs of the company and in particular its financial position and profitability. Those who read them are concerned not with the past but with the future, and in particular the future profitability of the company. The Ordinance, however, is directed to the past. However, the Commissioner's focus is on the taxation of profits.

The Court found that in preparing its tax computations, the Company was entitled to treat its unrealised profits as not chargeable to tax. The Court noted that it is beyond argument that accounts drawn up in accordance with ordinary principles of commercial accounting must be adjusted for tax purposes if they do not conform to the underlying principle of taxation enunciated by the courts, even if these are not expressly stated in the statute. The principles of commercial accounting must give way to the core principle that profits are not taxable until they are realised and that profits must not be anticipated.

The Company was required to recognise unrealised gains in the financial statements, while the Court noted that other taxpayers may not be required to do so. The Court observed that the surprising effect of the Commissioner's contentions was that, without any statutory support in the taxing statute, taxpayers who carry on the business of trading in securities are taxable on their unrealised profits while those who carry on other businesses are not; and unlike larger businesses carrying on the same trade, small and medium sized businesses may choose whether or not to be taxed on their unrealised profits. The Court of Appeal noted that this is not merely surprising, but is also contrary to the express charging provisions for profits tax in Hong Kong.

Accordingly, the Court of Final Appeal held that the Company's financial statements, recorded both realised profits during the accounting period - which are assessable; and increases in the value of its trading stock during the period representing unrealised profits – which are not assessable.

On the question of losses, Lord Millett noted that strictly speaking, there is no exception to the rule that losses may not be anticipated. *"If at the end of an accounting period the value of an item of trading stock is the same as or greater than cost but it is sold in the following accounting period for less than cost, the loss is realised in the later period and cannot be brought forward to the earlier. This is the case even if the loss is realised before the accounts are signed off, for post-balance sheet events are relevant and can be taken into account only if they affect the position as at the balance sheet date."*

Lord Millett went on to say that it does not follow that an unrealised loss cannot be used to reduce liability for profits tax. In a proper case, this can be achieved by making provision in the profit and loss account for the diminution in the value of trading stock during the accounting period. At first glance, this seems to be merely another way of anticipating unrealised losses; but it is not. Auditors will not normally allow such a provision to be made unless they are satisfied that "*the diminution in value is material and likely to be permanent*." Moreover, if such a provision is made it can be challenged by the Commissioner. The case was cited where trading stock includes shares in a company that has become insolvent and the shares worthless. The taxpayer may properly write off the value of the shares by making an appropriate provision when the company is put into liquidation without waiting for the company to be dissolved.

Comment

The decision of the Court of Final Appeal, the highest court in Hong Kong, that a taxpayer cannot be assessed on unrealised profits, regardless of the accounting treatment adopted, should now be taken as a fundamental principle of Hong Kong taxation law. Anticipated or imputed profits must first be realised before they are subject to tax.

This decision should have a broader application, well beyond the present case of a company trading in securities. For instance, unrealised gains recognised on assets held at year-end should not be taxable until such time as the gain is realised on disposal of the asset. However, the Inland Revenue Department may try to restrict the impact of the decision (as it has previously done in *ING Baring Securities (Hong Kong) Limited v CIR* and *Li & Fung (Trading) Limited v CIR*) particularly to situations factually similar to *Nice Cheer*.

Taxpayers should review their treatment of unrealised gains and losses to ascertain whether it reflects the approach in *Nice Cheer*. Moreover, claims for unrealised losses may come under closer scrutiny and potentially challenged by the Department in future.

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