Deloitte.
德勤

Tax
Issue H52/2013 – 22 November 2013

Tax Analysis

Authors:

Hong Kong

Davy Yun
Tax Partner
Tel: +852 2852 6538
Email: dyun@deloitte.com.hk

Finsen Chan
Senior Tax Manager
Tel: +852 2852 5612
Email: finchan@deloitte.com.hk

Evy Wong
Tax Manager
Tel: +852 2852 6594
Email: ewong@deloitte.com.hk

Hong Kong

CFA holds unrealized gains not chargeable to profits tax

Hong Kong's Court of Final Appeal (CFA) ruled on 12 November 2013 that unrealized gains arising from the revaluation of trading securities that were recognized in accordance with ordinary commercial accounting principles were not chargeable to profits tax under section 14 of the Inland Revenue Ordinance (*Nice Cheer Investment Limited v. Commissioner of Inland Revenue* (CIR)). The CFA is the court with final adjudication power on the laws of Hong Kong.

Background

The taxpayer is a Hong Kong company principally engaged in the trading of securities quoted on the Hong Kong stock exchange. It prepared its financial statements in accordance with the prevailing accounting standards and recognized realized and unrealized gains and losses on trading stock in its financial statements for the relevant periods. The unrealized gains and losses were recognized on the changes in the fair value of the unsold trading stock held at year end.

The taxpayer treated the unrealized gains as nontaxable income, but claimed a tax deduction for the unrealized losses. The CIR took the position that the unrealized gains arising from the unsold stock should be treated as taxable. The CIR's reasoning was that profits tax should be assessed according to the applicable accounting principles.

The taxpayer appealed the CIR's tax assessments. The case went to the Court of First Instance (CFI) in 2011, the Court of Appeal in 2012 and finally the CFA in 2013. The taxpayer prevailed at all levels, with all courts concluding that the unrealized gains should not be recognized for profits tax purposes and thus were not chargeable to profits tax.

Decision of the CFA

The CFA held in favor of the taxpayer concluding that the unrealized gains from revaluation of trading securities were not taxable, whereas unrealized losses may be deductible.

In accordance with the applicable statutory provision (section 14 of the Inland Revenue Ordinance (IRO)), the court stated that "profit" must derive from some trade, professional or business activity, and not merely result from a revaluation of assets held for the purpose of a trade, profession or business. As such, increases in the value of trading stock during the relevant period that represent unrealized profits should be excluded when computing assessable profits and are not chargeable to tax.

On the question of unrealized losses, the CFA noted two cardinal principles of tax law: (i) the word “profits” connotes actual or realized profits, not potential or anticipated profits; and (ii) neither profits nor losses may be anticipated. However, the court commented that the latter principle should not be interpreted to prohibit a taxpayer from using an unrealized loss to reduce its liability to tax; a taxpayer can “make a provision in the profit and loss account” for the diminution in the value of the trading stock, but this provision must be justifiable.

Comments

The CFA decision is clear and unambiguous that unrealized gains on trading securities should be nontaxable. The court held that such gains are anticipated and are not "profits" for purposes of section 14 of the IRO. In preparing tax computations, a taxpayer should be entitled to remove the amounts of its unrealized profits as not chargeable to tax.

Aside from the treatment of unrealized gains, additional observations on the CFA's decision in *Nice Cheer* are below. Companies should review their approach to handling these tax matters and discuss these matters with tax professionals.

Unrealized losses – Taxpayers should consider the tax treatment of unrealized losses. The CFA noted that neither profits nor losses may be anticipated, but it did not unambiguously prohibit the recognition of unrealized losses, as it did for unrealized gains. The court mentioned that a taxpayer may make a provision in the profit and loss account for the diminution in value of trading stock during the accounting period, but this provision must be justified.

The CFA’s decision is not straightforward on the treatment of unrealized losses. It is not entirely clear in what situations a provision would be considered “justified.” In particular, the court made no comment on section 19D, which requires that the amount of loss incurred by a person chargeable to tax for a year of assessment be computed in a like manner as the assessable profits for that year of assessment. Disputes between taxpayers and the IRD on the deductibility of unrealized losses are likely.

Other unrealized gains – The CFA’s decision raises the issue of whether all unrealized gains recognized in financial statements should be treated as nontaxable under the same principle the court applied to unrealized gains from revaluation of trading securities in *Nice Cheer*. In particular, the court emphasized that the words "every person" in section 14 of the IRO means that the section should be applied in the same way to every taxpayer to which the statute applies, regardless of the nature or size of the business. Accordingly, it seems the decision may be applied to other unrealized gains, such as those arising from the trading of debt securities (e.g. bonds) and other financial instruments. However, it is possible that the IRD may try to limit the application of *Nice Cheer*, e.g. to only situations involving the trading of equity securities, etc. It is yet to be seen how the IRD will interpret and apply the decision.

Exchange differences – The CFA did not comment on the treatment of foreign exchange transactions, as this was not at issue in the case. However, the CFI stated that the *Nice Cheer* decision should not be universally applied to foreign exchange transactions because unrealized gains and losses from foreign exchange transactions are different than those from trading securities; the underlying trading assets for foreign exchange transactions are currencies (money), i.e. fungible assets that have a ready market and a value against the reporting currency. In view of the above, it is unlikely that the IRD will accept the treatment of unrealized gains from foreign exchange transactions as nontaxable.

Tax follows accounting principle – It is interesting to note that Lord Millett, the judge in *Nice Cheer* and *Secan* (*CIR v. Secan Ltd. & Ranon Ltd.*), opined in *Nice Cheer* that the IRD had misread his decision in the *Secan* case. The *Secan* decision led the IRD to issue Departmental Interpretation and Practice Notes No. 40 – Prepaid or deferred revenue expenses (DIPN 40) and No. 42 – Taxation on financial instruments and foreign exchange differences (DIPN 42). In the IRD's view, the essence of the *Secan* case is that tax treatment should follow the treatment prescribed under the accounting rules unless the accounting rules are contrary to any provision of the tax statute, i.e. "tax follows accounting." However, the CFA stated that financial statements are prepared for investors' use in understanding the company's financial position and profitability, especially its future profitability; they are not prepared for tax purposes:

> *"It is clear beyond argument that accounts drawn up in accordance with the ordinary principles of commercial accounting must nevertheless be adjusted for tax purposes if they do not conform to the underlying principles of taxation enunciated by the courts even if these are not expressly stated in the statute."*

This raises the issue of to what extent "tax should follow accounting" and how this principle may evolve in the future. Following the judgment in the *Nice Cheer* case, it remains to be seen whether the IRD may revise DIPN 40 and DIPN 42.

Sharkey v. Wernher principle – The *Sharkey v. Wernher* principle, based on a 1955 UK tax case, generally is applied when a taxpayer's intention of holding an asset changes from trading to long-term investment, or vice versa. When the principle applies, the fair market value of the asset at the time the intent is changed is taken into account in computing the taxpayer's assessable profits. In *Nice Cheer*, the CFI specifically rejected the application of the *Sharkey v Wernher* case principle in Hong Kong and expressed that a taxpayer cannot trade with itself and that notional profits should not be chargeable to tax. The CFA, however, did not comment on the applicability of the *Sharkey v. Wernher* principle, likely because this issue was not raised. It remains to be seen whether this principle will continue to apply in practice in Hong Kong.

Refiling prior year assessments – Section 70A of the IRO allows a taxpayer to apply for correction of an assessment within six years after the end of a year of assessment or within six months after the date on which the relative notice of assessment was served (whichever is later), if the assessment was excessive because of an error or omission in a return or statement. It is questionable if taxpayers will be allowed to reopen prior year assessments under section 70A based on the *Nice Cheer* decision. Technically, if an assessment was issued on the basis of, or in accordance with, general prevailing practice at the time the return or statement was made, no correction may be made under section 70A.

Conclusion

The *Nice Cheer* decision is welcome, as it reinstates the principle that unrealized profits are not taxable. Nevertheless, this decision also poses a challenge as to what extent "tax should follow accounting." In light of the growing complexity of accounting standards, professional judgment is needed. Taxpayers are advised to contact professional advisers on the possible tax impact this decision may have on their business.

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte China. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

Beijing
Kevin Ng
Partner
Tel: +86 10 8520 7501
Fax: +86 10 8518 7501
Email: kevng@deloitte.com.cn

Hong Kong
Sarah Chin
Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@deloitte.com.hk

Shenzhen
Constant Tse
Partner
Tel: +86 755 3353 8777
Fax: +86 755 8246 3222
Email: contse@deloitte.com.cn

Chongqing
Claude Gong
Partner
Tel: +86 23 6310 6206
Fax: +86 23 6310 6170
Email: clgong@deloitte.com.cn

Jinan
Eunice Kuo
Partner
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: eunicekuo@deloitte.com.cn

Suzhou
Frank Xu / Maria Liang
Partner
Tel: +86 512 6289 1318 / 1328
Fax: +86 512 6762 3338
Email: frakxu@deloitte.com.cn
mliang@deloitte.com.cn

Dalian
Frank Tang
Partner
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297
Email: ftang@deloitte.com.cn

Macau
Quin Va
Partner
Tel: +853 8898 8833
Fax: +853 2871 3033
Email: quiva@deloitte.com.hk

Tianjin
Jason Su
Partner
Tel: +86 22 2320 6680
Fax: +86 22 2320 6699
Email: jassu@deloitte.com.cn

Guangzhou
Constant Tse
Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: contse@deloitte.com.cn

Nanjing
Frank Xu
Partner
Tel: +86 25 5791 5208
Fax: +86 25 8691 8776
Email: frakxu@deloitte.com.cn

Wuhan
Justin Zhu
Partner
Tel: +86 27 8526 6618
Fax: +86 27 8526 7032
Email: juszhu@deloitte.com.cn

Hangzhou
Qiang Lu
Partner
Tel: +86 571 2811 1901
Fax: +86 571 2811 1904
Email: qilu@deloitte.com.cn

Shanghai
Eunice Kuo
Partner
Tel: +86 21 6141 1308
Fax: +86 21 6335 0003
Email: eunicekuo@deloitte.com.cn

Xiamen
Lynch Jiang
Partner
Tel: +86 592 2107 298
Fax: +86 592 2107 259
Email: lijiang@deloitte.com.cn

About the Deloitte China National Tax Technical Centre

The Deloitte China National Tax Technical Centre ("NTC") was established in 2006 to continuously improve the quality of Deloitte China's tax services, to better serve the clients, and to help Deloitte China's tax team excel. The Deloitte China NTC prepares and publishes "Tax Analysis", "Tax News", etc. These publications include introduction and commentaries on newly issued tax legislations, regulations and circulars from technical perspectives. The Deloitte China NTC also conducts research studies and analysis and provides professional opinions on ambiguous and complex issues. For more information, please contact:

National Tax Technical Centre
E-mail: ntc@deloitte.com.cn

Eastern Region
Leonard Khaw
National Leader & Partner
Tel: +86 21 6141 1498
Fax: +86 21 6335 0003
Email: lkhaw@deloitte.com.cn

Northern Region
Angela Zhang
Partner
Tel: +86 10 8520 7526
Fax: +86 10 8518 1326
Email: angelazhang@deloitte.com.cn

Southern Region
Davy Yun
Partner
Tel: +852 2852 6538
Fax: +852 2520 6205
Email: dyun@deloitte.com.hk

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.