Hong Kong Tax News

Nice Cheer Case Update:
Taxpayer Won Again in the Court of Final Appeal

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The Court of Final Appeal ("CFA") issued its decision in Nice Cheer Investment Limited v Commissioner of Inland Revenue ("CIR") on 12 November 2013 which was in favor of the taxpayer. It was held that unrealized profits arising from revaluation of trading securities reported in accordance with accounting standards were outside the intendment of s14(1) of the Inland Revenue Ordinance, therefore not chargeable to profits tax. For details, please refer to the CFA Judgment (FACV 23/2012).

Background

The taxpayer is a Hong Kong company whose principal business consists of trading in marketable securities quoted in Hong Kong. According to the applicable accounting principles, unrealized gains or unrealized losses on trading stock were recognized in its profit and loss accounts for the relevant periods. For accounting periods where there were such unrealized gains, in computing the assessable profits for profits tax purposes for the relevant period, the taxpayer excluded the unrealized gains on trading stock. However, for accounting periods where there were unrealized losses, such losses were taken into account for the purposes of profits tax assessment.

The CIR was of the view that the unrealized gains arising from revaluing the unsold stock should be included in the profits tax assessments and accordingly issued profits tax assessments to this effect ("Tax Assessments"). The CIR contends that profits tax should be assessed according to the applicable accounting principles. Since unrealized losses were recognized for profits tax purposes in accordance with the applicable principles, unrealized gains should also be recognized for profits tax purposes in accordance with the applicable principles.

Tax issue under dispute

The taxpayer appealed against the CIR's Tax Assessments. The question for decision, therefore, is whether unrealized or holding gains derived from the revaluation of trading securities in Hong Kong at the year-end, which are ascertained in accordance with the ordinary commercial accounting principles, is chargeable to profits tax.

Case development

Court Level	Date of Judgment	Decision
Court of First Instance (CFI)	28 June 2011	Taxpayer won
Court of Appeal (CA)	19 June 2012	Taxpayer won
Court of Final Appeal (CFA)	12 November 2013	Taxpayer won

Decision of the CFA

The CFA held that the taxpayer's financial statements, prepared in accordance with mandatory international accounting standards, record both profits which the taxpayer has realized during the accounting period (which are assessable to tax) and increases in the value of its trading stock during the period i.e. unrealized profits (which are not assessable to tax). In preparing its tax computations, the taxpayer was entitled to remove the amounts of its unrealized profits as not chargeable to tax. 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 principle of taxation enunciated by the courts even if these are not expressly stated in the statue. In particular, principles of commercial accounting must give way to the core principles that profits are not taxable until they are realized and that profits must not be anticipated. While neither profits nor losses may be anticipated, it is not true to say that the taxpayer may not use an unrealized loss to diminish his liability for tax. If the unrealized loss is in the nature of a provision for the diminution in the value of trading stock during the accounting period, such provision for a diminution in value may be allowable provided that it is justifiable.

35/F One Pacific Place
88 Queensway
Hong Kong