HCIA 8/2007

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE
INLAND REVENUE APPEAL NO. 8 OF 2007

BETWEEN

NICE CHEER INVESTMENT LIMITED Appellant

and

COMMISSIONER OF INLAND REVENUE Respondent

Before: Hon To J in Court
Dates of Hearing: 22 - 23 March 2011
Date of Judgment: 28 June 2011

J U D G M E N T

INTRODUCTION

Introduction

1. This is an appeal by the taxpayer ("Taxpayer") against the determination ("Determination") of the Deputy Commissioner of Inland Revenue ("Deputy Commissioner") in confirming the profits tax assessments for the years of assessment 2003/04 to 2005/06 issued to the Taxpayer by the assessor. At the invitation of the Taxpayer, the Commissioner of Inland Revenue ("Commissioner") consented to transfer

the appeal from the Inland Revenue Board of Review to the Court of First Instance, pursuant to section 67 of the Inland Revenue Ordinance (Cap 112) ("the Ordinance").

2. The central question in this appeal is whether unrealised gains arising from the revaluation of trading investments, being securities listed in Hong Kong, to their respective market value at the balance sheet date and credited in its profit and loss account according to ordinary commercial accounting principles is chargeable to profits tax.

The background

3. The Taxpayer is a private company incorporated in Hong Kong on 8 September 1999. It commenced business on 7 October 1999 and adopted 31 March as its account closing date. Its principal activity was investment trading.

4. Over the years, the Taxpayer submitted its profits tax returns for the years of assessment 1999/2000 to 2005/06 together with audited accounts and proposed tax computations with supporting schedules. In its auditor's report accompanying the accounts, its auditor PricewaterhouseCoopers ("Auditors") expressed the opinion that the accounts gave a true and fair view of the state of affairs of the Taxpayer and of its profits or losses for the respective financial years. The Auditors also stated:

> "(i) that the [Taxpayer's] accounts had been prepared in accordance with accounting principles generally accepted in Hong Kong; and
>
> (ii) that the Auditors conducted their audit in accordance with Statements of Auditing Standards issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") (formerly known as the Hong Kong Society of Accountants ("HKSA")) and the audit included, inter alia, an assessment of whether the accounting policies are appropriate to the circumstances of the [Taxpayer], consistently applied and adequately disclosed."

5. In the preparation of its accounts for the various financial years up to 31 March 2005, the Taxpayer adopted ordinary commercial accounting principles and Statement of Standard Accounting Practice 24 ("SSAP 24") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), formerly known as Hong Kong Society of Accountants ("HKSA"). Note 2(a)(i) and (b) of the Notes to the Financial Statements attached to the Taxpayer's accounts for the accounting years up to 2004/05 contained the following statement in respect of its accounting policies:

> "(a) Revenue recognition
>
> (i) Realised and unrealised gains and losses on trading investments
>
> Realised gains and losses on trading investments are recognised on conclusion of sales contracts. Unrealised gains and losses on

> trading investments are recognised on the basis set out in note 2(b).
>
> (b) Trading investments
>
> Trading investments are stated at fair value at the balance sheet date. Fair value represents the quoted market price for investments which are listed or actively traded in a liquid market. For investments which are unlisted …
>
> At each balance sheet date, the net unrealised gains or losses arising from the changes in fair value of trading investments are recognised in the profit and loss account. Profits or losses on disposal of trading investments, representing the difference between the net sales proceeds and the carrying amounts, are recognised in the profit and loss account as they arise."

6. With effect from 1 January 2005, the Taxpayer adopted another standard, Hong Kong Accounting Standard 39 ("HKAS 39"), issued by the HKICPA under which both unrealised gains or losses arising out of revaluation of trading securities were also treated as profits or losses in the profit and loss account. For the purpose of this appeal, that change is immaterial. Note 2(d) and (i) of the Notes to the Financial Statements attached to the Taxpayer's accounts for the year ended 31 March 2006 contained the following statement of its accounting policies:

> "(d) Trading securities
>
> Trading securities are stated at fair value at the balance sheet date. Fair value represents the quoted market price for securities which are listed or actively traded in a liquid market.
>
> Regular purchases and sales of investments are recognised on trade-date, the date on which [the Taxpayer] commits to purchase or sell the asset. Transaction costs are expenses in the income statement.
>
> At each balance sheet date, the net unrealised gains or losses arising from the changes in fair value of trading securities are recognised in the income statement. Profits or losses on disposal of trading securities, representing the difference between the net sales proceeds and the carrying amounts, are recognised in the income statement as they arise."
>
> "(i) Revenue recognition
>
> (i) Realised and unrealised gains and losses on trading securities

> Realised gains and losses on trading securities are recognised on conclusion of sale contracts. Unrealised gains and losses on trading securities are recognised on the basis set out in note 2(d)."

7. Profits tax is chargeable under Part IV of the Ordinance. Section 14(1) is the charging section for profits tax. In computing the adjusted losses or assessable profits, the Taxpayer excluded the unrealised gains from the assessments but claimed deduction of the unrealised losses on trading investments/securities at year end. The assessor was of the view that the unrealised gains and losses arising from revaluing the unsold listed securities held at the year end should be included in the profits tax computation for the year of assessment in which the unrealised gains were credited and the unrealised losses were debited in the Taxpayer's accounts. Accordingly, the assessor issued computations of loss for the years of assessment 1999/2000 to 2002/03 and profits tax assessments for the years of assessment 2003/04 to 2005/06. The differential between the profits tax thus assessed over the years and that calculated by the Taxpayer without taking into account the unrealised gains was very substantial, being in the region of $250 million.

The accounting experts' opinion

8. There were no substantial disputes between the Taxpayer's accounting expert and the Commissioner's. There were no disputes that the Taxpayer's accounts for the various financial years were prepared in accordance with the then prevailing accounting practice.

9. By way of background, up until 31 December 1998, the common accounting practice in Hong Kong in reporting listed securities was to follow the International Accounting Standard 25 Accounting for Investments issued in March 1986, by using the lower of cost or market value of the investment. The diminution in value of investments (unrealised losses) was recorded as a provision and charged to profit and loss account, while the increase in value of investments (unrealised gains) were not reflected in the balance sheet or the profit and loss account.

10. The Council of HKICPA developed and issued its own financial reporting standards, including SSAP 24 which became applicable to accounting statements for periods beginning on or after 1 January 1999 until its replacement by HKAS 39 with effect from 1 January 2005.

11. SSAP 24 departed from the conventional practice of measuring financial instruments at the lower of historical cost or market value in the financial statements. It introduced the concept of fair value, holding gains and holding losses for trading stocks. Trading stocks were carried at fair value at the balance sheet date and holding gains and losses were included in profits or losses for the period. The holding gains and losses were not the result of actual trading but movements in fair value due to market conditions. In practice, the increase or decrease in fair value was included in other operating income and other expenses respectively on the face of the income statement; while detailed descriptions

such as unrealised holding gains on investment securities were disclosed in the notes to the financial statements.

12. HKAS 39 which replaced SSAP 24 with effect from 1 January 2005, introduced more detailed accounting treatment, classification of investments and measurement of financial instruments at fair value. The accounting treatment for trading stocks under HKAS 39 is as follows. On initial recognition, trading stocks are measured at their fair value in the balance sheet. Recognition is defined as the process of incorporating an item in the balance sheet or income statement. After initial recognition, trading stock are measured at their fair value without any deduction for transaction costs which may be incurred on sale or disposal. Such measurements are usually done on balance sheet date. Gains or losses arising from a change in fair value are recognised in profit or loss account. Profit or loss is defined in the Glossary of HKAS 39 as the total of income less expenses, excluding the components of other comprehensive income. As with the practice under SSAP 24, the profits or losses recognised under HKAS 39 are the result of a series of accounting treatments and classification when there may or may not have been any underlying trading activities.

13. According to the opinion of the Taxpayer's expert, where there were no trading activities, the profits or losses recognised under HKAS 39 merely reflect the changes in fair value of the trading stock and not profits made from a trading of the trading stock as there has not been any disposal. The Commissioner's expert did not respond to this opinion. On a fair reading of HKAS 39, the Taxpayer's expert must be right.

The Taxpayer's contention and the Commissioner's contention

14. The Taxpayer's contention is that at all times it engaged in investment trading and had been crediting such unrealised gains arising out of revaluation, not trading, into its profit and loss accounts for the years of assessment in question because of the new accounting standards promulgated by HKICPA, namely SSAP 24 and HKAS 39. Both standards require unrealised gains in respect of the listed securities held by the Taxpayer as trading stock to be included in its profit and loss account. It prepared its accounts in compliance with those accounting standards. The Taxpayer's case is that such unrealised gains arising through revaluation are not chargeable to profits tax for the purpose of section 14(1) of the Ordinance for the following reasons:

(1) the word "profits" as used in section 14(1) of the Ordinance means real profits and not notional profits;

(2) 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

(3) SSAP 24 and HKAS 39 cannot have the effect of changing the meaning and scope of the word "profits" in section 14(1).

The Taxpayer's approach is essentially one of statutory construction as to the meaning of the word "profits".

15. The Commissioner's contention can be summarised as follows:

(1) whether an item of gain or loss is chargeable for profits tax or deductible as an expense turns on the proper interpretation of the relevant provisions in the tax regime, in the present case, sections 14, 16, 17 and 18 of the Ordinance;

(2) under the statutory regime, profits and losses must be ascertained in accordance with ordinary principles of commercial accounting as modified to conform with the Ordinance;

(3) the Taxpayer's financial statements were on its own case, properly drawn up according to the prevailing accounting standards, namely SSAP 24 and HKAS 39 and did reflect the unrealised gains arising from revaluation of the listed securities; and

(4) this is not a case of charging profits tax on notional profits or anticipated profits.

16. While purporting to adopt a statutory construction approach in sub-paragraph (1) above, in his Determination the Deputy Commissioner in fact gave precedence to ordinary commercial accounting principles in ascertaining profits without construing the word "profits" in section 14(1). Then, in purportedly applying the decision of the Court of Final Appeal in *Commissioner of Inland Revenue and Secan Ltd & Another* (2003) 3 HKCFAR 411, the Deputy Commissioner assessed profits tax on the Taxpayer's unrealised gains arising from revaluation of the listed securities as stated in the Taxpayer's financial statements drawn up according to the prevailing accounting standards which the Deputy Commissioner considered were not inconsistent with the Ordinance. In this appeal, Mr Yuen SC, counsel for the Commissioner, also adopted a similar approach.

Relevance of ordinary commercial accounting principles in ascertaining profits before and after Secan Ltd

17. The decision in *Secan Ltd* was accorded great prominence by the Commissioner. It formed the basis of the Commissioner's Departmental Interpretation and Practice Notes No. 40 (Revised) and 42. Mr Yuen SC submitted that in *Secan Ltd* the Court of Final Appeal placed the relevance of generally accepted accounting principles in determining assessable profits on an even higher level than ever acknowledged. He further submitted that the Taxpayer's case have to be viewed in the light of *Secan Ltd*. Thus, the Commissioner's case in this appeal is squarely based on *Secan Ltd*. I now turn to examine the authorities before *Secan Ltd* on the use of ordinary commercial accounting principles in ascertaining profits.

18. Ordinary commercial accounting principles have always played an important role in ascertaining profits for revenue purposes. As submitted by Mr Yuen SC, quoting *Commissioner of Inland Revenue v Cock Russell And Co Ltd* (1949) 29 TC 387 and *Johnston (Inspector of Taxes) v Britannia Airways Ltd* [1994] STC 763, since early times the courts had been assessing taxable profits by reference to the taxpayer's own accounts provided such accounts were prepared in accordance with prevailing accounting standards and were not contrary to any statutory provisions. In *Usher's Wiltshire Brewery Ltd v Bruce* [1915] AC 433, the House of Lords held that in ascertaining profits ordinary commercial accounting principles are to be applied as follows. First, one must ascertain the profits of the trade in accordance with ordinary commercial accounting principles. That, of course, involves bringing in as items of expenditure such items as would be treated as proper items of expenditure in a revenue account made up in accordance with the ordinary principles of commercial accountancy. Secondly, one must adjust this account by reference to the express prohibitions contained in the relevant statute. I have no doubt about this well established principle. The rationale for this principle is best explained by Sir Thomas Bingham MR in *Gallagher v Jones* [1994] Ch 107 at 134. In essence, the rationale is that as such principles were formulated by the accounting profession for the very purpose of ascertaining the profits or losses of a business they are the most accurate rules for ascertaining profits or losses.

19. Mr Yuen SC tried to impress upon me the primacy of ordinary commercial accounting principles. He quoted the following dicta of Sir Thomas Bingham MR in *Gallagher v Jones* as authority for his proposition that no judge-made rule could override the application of a generally accepted rule of commercial accountancy:

> "The object is to determine, as accurately as possible, the profits or losses of the taxpayers' businesses for the accounting periods in question. Subject to any express or implied statutory rule, of which there is none here, the ordinary way to ascertain the profits or losses of a business is to apply accepted principles of commercial accountancy. That is the very purpose for which such principles are formulated. As has often been pointed out, such principles are not static: they may be modified, refined and elaborated over time as circumstances change and accounting insights sharpen. But so long as such principles remain current and generally accepted they provide the surest answer to the question which the legislation requires to be answered. …
>
> … Indeed, given the plain language of the legislation, I find it hard to understand how any judge-made rule could override the application of a generally accepted rule of commercial accountancy which (a) applied to the situation in question, (b) was not one of two or more rules applicable to the situation in question and (c) was not shown to be inconsistent with the true facts or otherwise inapt to determine the true profits or losses of the business." (My emphasis underlined)

20. Ordinary commercial accounting principles are useful and important in ascertaining profits and losses. However, their importance cannot be over-emphasised. Sir Thomas Bingham MR cautiously indicated that such accounting principles were subject to express or implied statutory rules. His Lordship's statement that no judge-made rule could override the application of a generally accepted rule of commercial accountancy was qualified by the phrase "the plain language of the legislation" applicable to the case before his Lordship. That statement is not unqualified. In my view, ordinary commercial accounting principles apply in the absence of statutory provisions to the contrary. If there are statutory provisions applicable to the situation, then interpretation of the statutory provision and judge-made rules in interpretation have precedence over ordinary commercial accounting principles. For example, the financial statement of an international corporation includes global profits. Those profits fall to be ascertained on ordinary commercial accounting principles. But which of those profits in a tax regime, such as that in Hong Kong which only charges tax at source, is chargeable to profits tax must be a question of interpretation of the law under the tax regime. With respect, Mr Yuen SC's proposition that no judge-made rule may override ordinary commercial accounting principles is unduly over-sweeping. The question of what profits are chargeable to tax must be decided on legal principles particularly principles of statutory construction. The question of how much is the chargeable profits must be decided according to ordinary commercial accounting principles. Put in another way, within the realm of ascertainment of profits, ordinary commercial accounting principles prevails; but which of those profits are chargeable to tax is prescribed by the statute. Outside that realm of ascertainment of profits, the judge's interpretation of the law must override ordinary commercial accounting principles.

21. That was the position before *Secan Ltd.* The next question is whether *Secan Ltd* has, as Mr Yuen SC submitted, elevated ordinary commercial accounting principles above the statute or the judge's interpretation of the statute. In *Secan Ltd*, the taxpayer acquired a development site during its first year of trading in 1988. The development cost was financed by borrowing. It elected to capitalise the interest charges by treating them as part of the cost of the development. The taxpayer brought its assets, including work in progress and completed flats held for sale into its balance sheet at the lower of cost or net realisable value. As the value of the assets equalled or exceeded costs, they appeared in the balance sheet at cost. This method of accounting treatment was adopted until 1991 when the taxpayer began to make sales of completed flats. Then it elected to rewrite its accounts retrospectively in order to set the whole of the interest charges for the earlier years as well as that of the current year against the proceeds of sales of completed flats made in the current year. At page 415, the Court of Final Appeal identified the central question in that case as:

> "The central question in these appeals, though not expressed in such terms in the Courts below, is whether the Inland Revenue Ordinance Cap. 112, ("the Ordinance") prohibits the capitalisation of interest for the purpose of computing the taxpayer's assessable profits and allowable losses. The resolution of that question depends on the proper accountancy treatment of capitalised interest, ..."

22. The issue before the Court of Final Appeal in *Secan Ltd* was a very narrow one. There was no dispute whether profits from the sale of completed flats were chargeable to profits tax. There was no question whatever about unrealised profits, notional gains or self trading. The dispute was how those profits were to be ascertained because there were two different accounting treatments as regards deduction of interests. The focal point was on the accounting treatment of interests incurred in the development for the purpose of generating the profits. The issue was therefore whether the Ordinance prohibits the capitalisation of interest for the purpose of computing the taxpayer's assessable profits and allowable deductions. The Court of Final Appeal held that the resolution of that question depended on the proper accountancy treatment of capitalised interest. Lord Millett NPJ said at 419:

> "Both profits and losses therefore must be ascertained in accordance with the ordinary principles of commercial accounting as modified to conform with the Ordinance. Where the taxpayer's financial statements are correctly drawn in accordance with the ordinary principles of commercial accounting and in conformity with the Ordinance, no further modifications are required or permitted. Where the taxpayer may properly draw its financial statements on either of two alternative bases, the Commissioner is both entitled and bound to ascertain the assessable profits on whichever basis the taxpayer has chosen to adopt. He is bound to do so because he has no power to alter the basis on which the taxpayer has drawn its financial statements unless it is inconsistent with a provision of the Ordinance. But he is also entitled to do so, with the result that the taxpayer is effectively bound by its own choice, not because of any estoppel, but because it is the Commissioner's function to make the assessment and for the taxpayer to show that it is wrong.
> (My emphasis underlined)

23. In the above passage, Lord Millett NPJ made it amply clear that the ordinary commercial accounting principles used to ascertain profits and losses have to be modified to conform with the Ordinance. The Court of Final Appeal then made a finding that the Ordinance did not prohibit capitalisation of interest. As the Ordinance did not prohibit capitalisation of interest, and as there were two alternative basis under ordinary commercial accounting principles on which profits may be ascertained, one with capitalisation of interest and one without, the Commissioner was both entitled and bound to ascertain the assessable profits on whichever basis the taxpayer had chosen to adopt. In other words, if the Ordinance had prohibited capitalisation, the accounting principles based on capitalisation of interest had to be struck out or modified to conform with the Ordinance. In that case, profits and losses may not be ascertained with interests capitalised.

24. With respect to Mr Yuen SC, I think he has mis-interpreted *Secan Ltd* by ignoring the important qualification that ordinary commercial accounting principles have to be modified to conform with the Ordinance and hence quoted the dicta of Lord Millett NPJ out of their proper context. In fact, this important qualification has found its way in all the authorities quoted by counsel. Ignoring this qualification tantamount to giving to accountants the role not just of determining profits, losses and profits tax, but also the power to make laws and rewrite the Ordinance. In my view, I do not think Lord Millett NPJ was

putting ordinary commercial accounting principles at any level higher than that accorded to them by *Gallagher v Jones*.

The proper approach

25. Mr Yuen SC submitted that only two questions call for consideration in this appeal: firstly, whether the relevant accounts of the Taxpayer were prepared in accordance with the prevailing accounting standards; and if yes, whether the way in which the Taxpayer's accounts were prepared was contrary to any provisions in the Ordinance, in that the Ordinance prohibits inclusion of unrealised gains. These two questions posed by Mr Yuen SC were based on his misunderstanding of the effect of *Secan Ltd*. The answers to these questions must be in favour of the Commissioner because the financial statements were on the Taxpayer's case prepared in accordance with SSAP 24 and HKAS 39 and obviously there is no provision in the Ordinance expressly prohibiting inclusion of unrealised gains in financial statements which is not anything the Ordinance is enacted for. In my view, the first question in profits tax cases is always what profits are chargeable to tax. The two questions posed by Mr Yuen SC were based on the issues in dispute in *Secan Ltd* which was ascertainment of profits or allowable deductions. They failed to address the issue in dispute in the present case, which is what profits are chargeable to profits tax. That issue involves statutory construction as to the meaning of the word "profits" in section 14(1). With respect, I reject the approach suggested by Mr Yuen SC as it fails to address the central issue in dispute.

26. In my view, the proper approach to be adopted in determining tax liability is that as stated by Lord Millett NPJ in the Court of Final Appeal in *Collector of Stamp Revenue and Arrowtown Assets Ltd* (2003) 6 HKCFAR 517. The court should first ascertain the intendment of the legislature and then find out if what the taxpayer did was within the intendment of the particular statutory provision which is invoked. The first issue is one of statutory construction. The second is a finding of fact. Lord Millett NPJ said at 554:

> " It is a fundamental principle of the constitution of Hong Kong, as of the United Kingdom and the United States, that the subject is to be taxed by the legislature and not by the courts. In all three jurisdictions, therefore, every tax case, that is to say every question of tax or no tax, is ultimately a question of statutory construction. The question is always whether what the taxpayer did was within the intendment of the particular statutory provision which is invoked."

27. Counsel argued whether "profits" means real profits and does not include unrealised or notional profits; whether profits may be taxed before realisation; whether profits may be anticipated; and whether a man can trade with himself. I think these are principles of construction of income tax statutes. Whether the profits chargeable to tax have such effect depends on what is the meaning of the word "profits" under section 14(1) of the Ordinance according to the true and proper construction of the word.

28. As for application of ordinary commercial accounting principles to the dispute in this case, *Secan Ltd* properly applied would require to be determined first the question whether section 14(1) imposes any statutory modification to the profits and losses calculated according to ordinary commercial accounting principles, namely SSAP 24 and HKAS 39. That necessitates a comparison of assessable profits within the meaning of section 14(1) with the profits as calculated under SSAP 24 and HKAS 39. If the two types of profits are the same, no modification is required by the Ordinance. The profits as stated in the financial statements shall be chargeable to profits tax. If the two types of profits are not the same, then the financial statements would have to be adjusted to conform with the Ordinance. For example, if a taxpayer's financial statement includes global profits, it must be modified by taking out such of the profits which arose in or were derived from outside Hong Kong.

29. The title of SSAP 24 is "Statement of Standard Accounting Practice 24, Accounting for Investments in Securities". The objective of SSAP 24 as stated in its preamble was:

> "`The objective of this Statement is to prescribe principles for the accounting treatment and disclosure of investments in debt and equity securities. The major issues in accounting for investments in securities addressed by this Statement are the classification and measurement of different categories of investments, the treatment of holding gains and losses and disclosure of relevant information."

HKAS 39 replaced SSAP 24 with effect from 1 January 2005. The title of HKAS 39 is "Financial Instruments: Recognition and Measurement". Its objective as stated in paragraph 1 of HKAS 39 is:

> "The objective of this Standard is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items."

On the face, the objective of the two standards is to set out the principles for recognising and measuring financial assets at their fair value so that the balance sheet properly reflects the true value of the company. It is not aimed at setting the principles for ascertaining profits and losses, let alone profits for the purpose of profits tax under the Ordinance. The profits ascertained in the financial statements drawn up in accordance with SSAP 24 and HKAS 39 must be modified to conform with the Ordinance for profits tax purposes. What are not caught by the word "profits" within the meaning of section 14(1) should be taken out from the financial statements prepared in accordance with SSAP 24 and HKAS 39.

30. The issues raised in this appeal are:

(1) what is the meaning of the terms "profits" and "assessable profits" under section 14(1); and

(2) whether what the Taxpayer did was within the intendment of the charging section.

The first issue is one of statutory construction. The second issue is a question of fact.

Some general principles of statutory construction

31. Construction of a statute is essentially ascertainment of the intention of the legislature as expressed by the words used in the statute. In construing a tax statute as in construing any other statute, the court must bear in mind the general principle that it is necessary to read all of the relevant provisions together and in the context of the whole statute as one purposive unit in its appropriate legal and social setting, identify the interpretative considerations involved and weigh and balance them in case they conflict: per Bokhary PJ in *The Medical Council of Hong Kong And David Chow Siu Shek* (2000) 3 HKCFAR 144 at 154.

32. The principles which specifically govern the construction of tax statutes were succinctly summarised by Lord Donovan, giving the majority judgment of the Judicial Committee of the Privy Council in *Thomas Mangin And Inland Revenue Commissioner* [1971] AC 739 at 746:

> "These contentions pose the question of the true construction of section 108. Its history will be outlined presently; but it may be useful to recall at the outset some of the rules of interpretation which fall to be applied.
>
> First, the words are to be given their ordinary meaning. They are not to be given some other meaning simply because their object is to frustrate legitimate tax avoidance devices. As Turner J says in his (albeit dissenting) judgment in *Marx v Inland Revenue Commissioner* [1970] NZLR 182, 208, moral precepts are not applicable to the interpretation of revenue statutes.
>
> Secondly, "… one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used": per Rowlatt J in *Cape Brandy Syndicate v Inland Revenue Commissioners* [1921] 1 KB 64, 71, approved by Viscount Simons LC in *Canadian Eagle Oil Co Ltd v The King* [1946] AC 119, 140.
>
> Thirdly, the object of the construction of a statute being to ascertain the will of the legislature it may be presumed that neither injustice nor absurdity was intended. If therefore a literal interpretation would produce such a result, and the language admits of an interpretation which would avoid it, then such an interpretation may be adopted.

> Fourthly, the history of an enactment and the reasons which led to its being passed may be used as an aid to its construction."

33. Relying on *Arrowtown Assets Ltd*, Mr Wong, counsel for the Taxpayer, submitted that the court should adopt a purposive approach in construing section 14(1) and reach the conclusion that the legislature must have intended taxpayers to pay profits tax on real profits actually earned and realised and not on a notional gains which have no existence whatsoever save in the books and accounts of the taxpayer concerned. I do not think Lord Millett NPJ was laying down any legal principle that the purposive approach must be adopted in all cases. The principle his Lordship laid down was that the court has to ascertain the intendment of the legislature. That intendment is to be ascertained by examining the charging section in the light of the tax regime as a purposive unit. If it is possible to ascertain the purpose of the legislature, the court shall give effect to that legislative purpose by applying such meaning to the words used in the enactment which those words are capable of having. The court may do so even to the extent of applying a strained meaning to the words used if the literal meaning is not in accordance with the legislative purpose. This purposive construction may only be adopted if the legislative purpose can be clearly discerned. Where, however, the court is unable to ascertain the purpose of an enactment or is doubtful as to its purpose, the court can only ascertain the legislative intent from the language used and give effect to that purpose. The words used shall be given their ordinary meaning. Nothing is to be added, nothing is to be implied. The literal rule of construction applies.

34. In *Arrowtown Assets Ltd*, the Court of Final Appeal was able to discern the purpose of section 45 of the Stamp Duty Ordinance was to provide relief from stamp duty in the case of a transfer of the beneficial interest from one associated body corporate to another. Hence, the Court of Final Appeal was able to adopt the purposive approach of statutory interpretation.

35. Mr Wong did not address me as to how he could have ascertained that the intention of the legislature was what he advocated. There is no indication from the Ordinance the precise nature and extent of the mischief which the legislature intended to prevent by the Ordinance. The short title of the Ordinance reads:

> "To impose a tax on property, earnings and profits."

This is all the guidance one can get from the title of the Ordinance.

36. Profits tax is chargeable under Part IV of the Ordinance. Part IV contains a charging section, section 14, which imposes a statutory obligation on every person carrying on a trade, profession or business in Hong Kong to pay profits tax. Specifically, section 15 provides for what payments are treated as receipts; section 16 provides for how assessable profits are to be ascertained; and section 17 provides for what may be deducted from profits. Thus, to calculate assessable profits, the taxpayer starts with all the profits arising in or derived from his trade, profession or business arising in or derived from Hong Kong, and deducts from it all outgoings and expenses to the extent to which they were incurred during

the basis period for that year of assessment in the production of the profits. Some specific outgoings and expenses are defined in section 16. The section excludes all outgoings and expenses, including certain particular items of expenses specified in the section from calculation of chargeable profits, such as interests, rent, overseas tax paid, bad debts, cost of repairs etc and other payments under an approved retirement scheme, contributions to Mandatory Provident Fund Schemes for employees, expenditure on research and development and charitable donations under some other sections in Part IV. The profits so computed shall, if applicable, be subject to adjustment under section 18F by deducting the allowance for depreciation for plant and machineries and adding the balancing charge in accordance with provisions of Part VI. Section 16 does not identify the source from which such deductions are to be made. That source cannot be anything else but profits arising in or derived from Hong Kong. The profits left after deducting all outgoings and expenses are assessable profits, which will be taxed at the standard rate according to section 14(1).

37. With respect to Mr Wong, reading Part IV as a whole, I am unable to discern any purpose in Part IV or specifically in sections 14(1) or 16 of the Ordinance other than to charge tax on profits according to a set of rules as provided in Part IV. In a general tax statute, of which the Ordinance is one, it is difficult to discern any purpose other than to raise public revenue by a system of taxation which is to be applied consistently to those who are caught within the tax net, but not necessarily fairly to all subjects within the net. What is important is consistency and not fairness. In the absence of clear indication of what the legislative purpose was, it is not appropriate for me to speculate or to subscribe to the Ordinance any particular purpose which I think the Ordinance would best serve. Other tax statutes may have an auxiliary purpose of achieving a re-distribution of wealth, social engineering or even restraint of trade. But that is certainly not the case with the Ordinance. In the circumstances, I think the literal rule of interpretation must prevail.

MEANING OF "PROFITS" AND "ASSESSABLE PROFITS"

38. The true meaning of the terms "profits" and "assessable profits" is at the heart of this appeal. I have outlined the tax regime under Part IV of the Ordinance in paragraph 36 above. I now turn to examine the charging section in order to construe the term "profits" and then the term "assessable profits" within the meaning of the charging section.

The charging section

39. I begin with the charging section and some definitions under section 2. Section 14(1) provides as follows:

> " Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part."

"Assessable profits" is defined under section 2 to mean:

> " the profits in respect of which a person is chargeable to tax for the basis period for any year of assessment, calculated in accordance with the provisions of Part IV".

"Profits arising in or derived from Hong Kong" is defined in section 2 as:

> " for the purposes of Part IV shall, without in any way limiting the meaning of the term, include all profits from business transacted in Hong Kong, whether directly or through an agent".

40. What is chargeable to profits tax is not "profits" as such, but "assessable profits". Thus, a person or corporation is liable to profits tax if during the year of assessment: (1) he carries on a trade, profession or business in Hong Kong; (2) makes profits arising in or derived from Hong Kong from such trade, profession or business; then (3) such of his profits as calculated in accordance with Part IV of the Ordinance shall be chargeable to profits tax. To construe the term "assessable profits", one begins with the word "profits" in its ordinary meaning, as subsequently qualified by the expressions "arising or derived from Hong Kong" and "from such trade, profession or business". I now turn to examine these individual elements in turn.

Meaning of "trade"

41. The words "trade" and "business" are defined under section 2 of the Ordinance. "Trade" is defined as including "every trade and manufacture, and every adventure and concern in the nature of trade". "Business" is defined as including "agricultural undertaking, poultry and pig rearing and the letting or sub-letting by any corporation to any person of any premises or portion thereof, and the sub-letting by any other person of any premises or portion of any premises held by him under a lease or tenancy other than from the Government". "Profession" is not defined.

42. As these definitions are not exhaustive, reference may be made to the ordinary meanings of these words. These words are defined in *Shorter Oxford English Dictionary, 6th edition* as follows. "Trade" means "buying and selling or exchange of commodities for profit." "Profession" means "a vocation, a calling, especially one requiring advanced knowledge or training in some branch of learning or science …; any occupation as a means of earning a living". "Business" means "a habitual occupation, a profession, a trade". These definitions do not give very precise meaning for these words. However, taken together with the statutory definition, one is able to have a flavour of what is meant by "trade, profession or business". These words, taken together, mean buying and selling of stock or rendering of services for profit.

43. In *Ransom (Inspector of Taxes) and Higgs* [1974] 1 WLR 1594, Lord Reid defined "trade" at 1600H as follows:

> " As an ordinary word in the English language "trade" has or has had a variety of meanings or shades of meaning. Leaving aside obsolete or rare usage it is sometimes used to denote any mercantile operation but it is commonly used to denote operations of a commercial character by which the trader provides to customers for reward some kind of goods or services."

At 1611B-C, Lord Wilberforce also said:

> " Trade involves, normally, the exchange of goods, or of services, for reward, not of all services, since some qualify as a profession, or employment, or vocation, but there must be something which the trade offers to provide by way of business."

44. In *Dublin Corporation v M'Adam* 20 L.R. Ir 497, 510; 2 T.C. 387, 397, Palles C.B. said:

> "On the other hand, I think it is perfectly clear that, in order to bring this case within the operation of the Income Tax Act, it is necessary that there shall be this trading in its strict true sense. There must be, at least, two parties – one supplying water, and the other to whom it should be supplied and who should pay for it. If these two parties are identical, in my opinion there can be no trading."

45. Summing up from these authorities, the essential elements of "trade" are that it is a commercial operation between two parties in which a trader provides goods or services to the other party for reward.

Whether a person can trade with himself

46. Arising from this meaning of the word "trade" is the much debated question of whether a person can trade with himself. Mr Yuen SC referred to the rule in *Sharkey (Inspector of Taxes) and Wernher* [1956] AC 58 and argued that the Taxpayer is deemed to have sold its closing stock of listed securities at the end of one accounting year to itself as its opening stock for the next accounting year. However, Mr Wong submitted that the concept of self-trading is contrary to a well established principle of construction of income tax statute that a person cannot trade with himself and that *Sharkey and Wernher* is distinguishable from the present case.

47. I begin with the two principles of construction of income tax statute relied on by the Taxpayer. The dissenting judgment of Lord Oaksey in *Sharkey and Wernher* is a convenient authority. These two principles of statutory construction were summarised by Lord Oaksey at 74:

> "I think this follows from two principles which have long been established on the construction of the Income Tax Acts. The first principle is that the "profits or gains" taxed are actual commercial profits and not mere benefits (see *Tennant v Smith* [1892] AC 150 and *Gresham Life Assurance Society v Styles* [1892] AC 309). The second is that a man cannot trade with himself in the sense in which the word "trade" is used in the Income Tax Acts. As Palles C.B. said in *Dublin Corporation v M'Adam*: "On the other hand, I think it is perfectly clear that, in order to bring this case within the operation of the Income Tax Act, it is necessary that there shall be this trading in its strict true sense. There must be, at least, two parties – one supplying water, and the other to whom it should be supplied and who should pay for it. If these two parties are identical, in my opinion there can be no trading. No man, in my opinion, can trade with himself; he cannot, in my opinion, make, in what is its true sense or meaning, taxable profit by dealing with himself; and in every case of this description it appears to be a question on the construction of the Act whether the two bodies – the body that supplies and the body or class that has to pay – were either identical, or, upon the true construction of the Act, must be admitted to have been held by the Legislature to be identical, and so legislated for upon that basis.
>
> In my opinion Palles C.B. was right and no authority inconsistent with his view was cited to your Lordships. The idea of a person trading with himself is inconsistent with the idea of ownership. An owner can do as he likes with his own property apart from legislation: he cannot be compelled to sell his own property to himself either at the market or any other value apart from legislation to that effect. Any sale so called which a trader makes to himself must be "notional" and not "actual". He cannot make a commercial profit or loss by transferring an asset from himself to himself or by a gift to someone else no matter what price he notionally ascribes to the transaction."

Though Lord Oaksey was dissenting, the statement of law his Lordship quoted is supported by well established authorities of the House of Lords.

48. In *Sharkey and Wernher*, the taxpayer carried on a stud farm business and a racing stable business. On transfer of five horses from the stud farm to the stables, the House of Lords held that where a person carrying on a trade disposed of part of his stock in trade not by way of sale in the course of trade but for his own use, enjoyment, or recreation, he must bring into his trading account for income tax purposes the market value of that stock in trade at the time of such disposition, and that accordingly, the amount to be credited to the stud farm account on transfer of the horses was their market value and not the cost of breeding them. The majority held that the taxpayer was deemed to have sold an item of stock to himself.

49. Viscount Simonds also referred to *Dublin Corporation v M'Adam* and *Gresham Life Assurance Society v Styles* relied on by Lord Oaksey but suggested that the principle that a man cannot be taxed on profits that he has not made has to be qualified.

Viscount Simonds circumvented that principle by the concept of notional receipt. His Lordship said at page 68 to 69:

> "[The principle] is only saying in another way that a trader is not to be charged with the receipt of sums that he might have, but has not, received, and this is equally true whether the sum with which it is sought to charge him is market value or production cost, whether it will result in a notional profit or a notional balancing of receipts with expenditure and whether the reason for his not in fact receiving such a sum is that the goods which are his stock in trade have perished in the course of nature or that he has chosen to use them for his own pleasure or otherwise dispose of them. The true proposition is not that a man cannot make a profit out of himself but that he cannot trade with himself. The question is whether and how far this general proposition must be qualified for the purposes of income tax law.

To emphasise the point on notional receipt, his Lordship continued:

> "Yet I cannot refrain from calling attention to what must be fundamental to the solution of the question,. For I cannot escape from the obvious fact that it must be determined whether and why a trader, who elects to throw his stock in trade into the sea or dispose of it in any other way than by way of sale in the course of trade, is chargeable with any notional receipt in respect of it, before it is asked with how much he should be charged.
>
> … Are the horses, the jewels, the cakes and ale to be treated for the purpose of income tax as disposed of for nothing or for their market value or for the cost of their production?"

Then, his Lordship referred to *Watson Brothers v Hornby* 168 LT 109, in which the court held that chicks transferred by the taxpayer from his hatchery to his poultry farm were to be chargeable at market price which was substantially below the taxpayer's cost of production from his own hatchery. That case was regarded as a case of a taxpayer selling to himself in one capacity what he produced in another and at market price.

50. After referring to the above authorities, Viscount Simonds reached the conclusion that the legislature had made inevitable invasion of the principle that a taxpayer cannot make a profit by selling to himself. That was because the legislature recognized a sort of artificial dichotomy that a taxpayer was regarded as carrying on more than one taxable activity. In *Sharkey and Wernher*, the taxpayer conceded that some figures must appear in the stud farm account as a receipt in respect of the five horses transferred to the stables. The dispute was whether the horses should be transferred at market price or at cost. Viscount Simonds said at page 72:

> "… Yet it seems to me that it is a necessary qualification of the broad proposition. For, if there are commodities which are the subject of a man's

> trade but may also be the subject of his use and enjoyment, I do not know how his account as a trader can property be made up so as to ascertain his annual profits and gains unless his trading account is credited with a receipt in respect of those goods which he has diverted to his own use and enjoyment. I think, therefore, that the admission was rightly made that some sum must be brought into the stud farm account as a receipt though nothing was received and so far at least the taxpayer must be regarded as having trade with himself. But still the question remains, what is that sum to be?"

51. In my view, *Sharkey and Wernher* did not overrule the principle that a man cannot trade with himself as a principle of construction of income tax statutes. Viscount Simonds only held that the principle was qualified by the relevant statutory provisions in that case. In *Sharkey and Wernher*, what were subject to tax were profits from various taxable activities. Stud farm and racing stables were two different taxable activities. Under that tax regime, it was possible for the court to accept the construction that some figures from one activity of the taxpayer be treated as receipts in his other activity. The decision was explained on the basis of notional receipt. It is far from establishing any principle of general application that a man can trade with himself.

52. Furthermore, by way of contrast, under our simple tax regime, which Hong Kong is always so proud of, what are chargeable to profits tax are profits from such trade, business or profession. The word "trade" could not have any other meaning than that ascribed to it by Lord Reid and Lord Wilberforce in *Ransom v Higgs*, i.e. buying and selling or exchange of commodities for profit between two parties to a commercial transaction. That meaning is confirmed by numerous authorities, including Lord Oaksey in *Sharkey and Wernher* and Palles CB in *Dublin Corporation v M'Ad*am. The idea that a person can trade with himself is inconsistent with the meaning of the word "trade".

53. The Inland Revenue Board of Review Decision in *D41/91* (1991) 6 IRBRD 211 and *D47/91* (1991) 6 IRBRD 256 have no difficulties in construing the word "profits" in section 14 as meaning real profits and not notional profits. The Board of Review doubted the applicability of the principle in *Sharkey and Wernher* to the Hong Kong tax regime. The chairman of the Board, Litton QC, as he then was, said respectively in paragraph 41 and paragraph 31 of the two decisions:

> "The charge on 'profit' in section 14 of the Inland Revenue Ordinance is a charge on real profit, not on notional profit which a taxpayer never made. … When it comes then to assess the Taxpayer, what principles of law, or of commercial accountancy, require the Taxpayer to be assessed on the basis of a sale at a notional figure and not the actual figure? We are aware of none."

54. In *Commissioner of Inland Revenue and Quitsubdue Ltd* [1999] 2 HKLRD 481, Yuen J, as she then was, held *obiter* that the principle in *Sharkey and Wernher* did not apply to Hong Kong whether generally or in the circumstances of that case. In that case, the taxpayer, a private company, acquired all the units in two buildings in 1986 and redeveloped the properties in 1987. The shares in the taxpayer company changed hands

twice in 1987. In respect of the second change, the Commissioner made additional profits tax assessment alleging a change in intention. The Commissioner assessed profits as a notional profit calculated as the difference between the cost and market value of the properties as at the date of change in intention. On appeal, the Board of Review held that there had been a change in intention, but no profits tax could be raised as the properties had never been disposed of by the taxpayer. The Commissioner appealed to the Court of First Instance. Yuen J dismissed the appeal, primarily on her finding that there was no change in intention on the part of the taxpayer and that a person could not be taxed on notional profits which he had not made. Then, her Ladyship specifically rejected the principle in *Sharkey and Wernher* as being applicable to Hong Kong. Her Ladyship explained at 492:

> "For the reasons set out below, I take the view that the principle in *Sharkey v Wernher* [1956] AC 58, 36 TC 275 does not apply, whether generally or in the circumstances of this case.
>
> The facts of that case are well-known. …
>
> This decision has remained good law in England, but has been questioned in Hong Kong (see the decisions of the Board of Review in *D41/91* 6 IRBRD 211 and *D47/91* 6 IRBRD 256 and the views of the authors of *Taxation of Property Transactions in Hong Kong* at pp.63-68).
>
> I start off with first principles. The undisputed principle is that a person cannot trade with himself (*Dublin Corp v M'Adam (Surveyor of Taxes*) 2 TC 387 at p.397, *Sharkey v Wernher* [1956] AC 58, 36 TC 275 at pp. 296, 298). If he cannot trade with himself, it must follow that he cannot make a profit out of trading with himself. The charge on profit in s.14 of the Inland Revenue Ordinance (Cap. 112) is a charge on real profit. So, it follows that a person cannot be charged with profits tax on "self-trade" as it does not exist.
>
> …
>
> For the reasons above, I take the view that to charge him with profits tax based on the market value of the commodity, when he has not trade at all, would be contrary to profits tax liability under s.14."

55. I am in total agreement with her Ladyship. The principle that a man cannot trade with himself is a well established principle of construction of income tax statutes. It may only be displaced by clear words in the statute. But there is nothing in the Ordinance which is inconsistent with this principle. Mr Yuen SC has not referred me to any statutory provision to that effect. The doubts as to the applicability of the principle in *Sharkey and Wernher* as expressed by the Inland Revenue Board of Review were well justified. In my opinion, despite *Sharkey and Wernher*, the principle that a man cannot trade with himself as a principle of statutory construction remains unshaken in Hong Kong. *Sharkey v Wernher*, which was decided on the basis of a very different tax regime, is inapplicable to Hong Kong.

It should cease to be quoted as an authority for the proposition that a man can trade with himself.

Ordinary meaning of "profits"

56. As the word "profits" is not defined under the Ordinance, its meaning would have to be ascertained from the ordinary meaning of the word which is best reflected by ordinary commercial accounting principles. Profit or loss is defined in the Glossary of HKAS 39 as the total of income less expenses, excluding the components of other comprehensive income.

57. There is a well established principle that the question of what are or are not profits or gains is a question of fact which must be ascertained by applying ordinary commercial accounting principles: see *Sun Insurance Office v Clark* [1912] AC 443 at 455 per Viscount Haldane and *Odeon Associated Theatres Ltd* per Sir John Pennycuick V-C. As was held by the House of Lords in *Usher's Wiltshire Brewery Ltd*, in ascertaining the profits of the trade, one begins with ascertaining profits in accordance with ordinary commercial accounting principles and then make additions and deductions according to the tax statute. In the present case, the relevant accounting principles are those as laid down in SSAP 24 and HKAS 39. According to those accounting principles, simply put, profits include actual profits from trading and the gains arising from a change in fair value of a financial asset held for trading purposes. In other words, under the prevailing accounting practice, unrealised profits arising from revaluation of listed securities are treated as profits. This principle must be respected.

Meaning of "profits arising in or derived from Hong Kong … from such trade, profession or business …"

58. This expression contains a geographical element and an operational element. The most obvious effect of this expression is to impose a geographical limitation on the profits chargeable to profits tax. The profits to which profits tax may be charged must have a Hong Kong source.

59. The second element in this expression is the qualification that the profits must arise from such trade, profession or business carried on by the taxpayer. In *Commissioner of Inland Revenue and Hang Seng Bank Ltd* [1991] 1 AC 306, Lord Bridge of Harwich in delivering the opinion of the Privy Council rejected counsel's argument that profits accruing from overseas trading in certificates of deposits were mere components of the profits of an entire business which arose in and derived from Hong Kong. His Lordship said at 318E-F:

> "Their Lordships cannot accept this submission. Three conditions must be satisfied before a charge to tax can arise under section 14: (1) the taxpayer must carry on a trade, profession or business in Hong Kong; (2) the profits to be charged must be "from such trade, profession or business," which their

> Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong; (3) the profits must be "profits arising in or derived from" Hong Kong."

And at 322H to 323B:

> "… But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected."

Though the focal point of Lord Bridge was directed at the geographic source of the profits, it is clear from the above passage that the profits to be chargeable to profits tax must have arisen in or been derived from some trading activities carried on by the taxpayer. This is also implicit from *Kwong Mile Services Ltd and Commissioner of Inland Revenue* (2004) 7 HKCFAR 275 at paragraph 11 per Bokhary PJ and *ING Baring Securities (Hong Kong) Ltd and Commissioner of Inland Revenue* (2007) 10 HKCFAR 417 at paragraphs 125-134 per Lord Millett NPJ.

60. This expression as a whole requires that the profits to be chargeable to profits tax must have been earned by the taxpayer from some trading activity which he has performed in Hong Kong. The inclusion in the definition of the expression "business transacted in Hong Kong" lends further support to this construction. In the context of section 14, the profits chargeable to profits tax must therefore be profits arising in or derived from some trading, or business or professional activities carried on by the taxpayer in Hong Kong.

Whether "profits" chargeable to profits tax means real profits and whether such profits can be anticipated

61. Associated with the above meaning of the expression are two other hotly debated issues: firstly, whether "profits" within section 14(1) means real profits and does not include gains arising from revaluation; and secondly, whether profits can be anticipated. The two issues are related. One is the corollary of the other. As I have already said, this is all a matter of statutory interpretation.

62. Mr Wong quoted the House of Lords decision in *Ostime (Inspector of Taxes) and Duple Motor Bodies Ltd* [1961] 1 WLR 739 in which Lord Reid said at 751 that "it is a cardinal principle that profit shall not be taxed until realised." As explained by Lord Salmon in *Willingale v International Commercial Bank Ltd* [1978] AC 834, this does not mean until profit has been received in cash, but means until it has been, accrued, ascertained or earned. The principle will be considered in this qualified form.

63. The Commissioner doubted if there is any such overriding principle of tax law. Mr Yuen SC argued that *Duple Motor Bodies* was doubted by the Court of Appeal in *Gallagher v Jones* for two reasons: firstly, the Court of Appeal considered that no judge-made rule can override a generally accepted rule of commercial accountancy and, secondly, the principle of no tax on profits until realised was but a re-statement of a statutory rule. I have already dealt with the first issue; i.e. primacy of ordinary commercial accounting principles. I now deal with the Commissioner's second point whether there is any legal principle in income tax law against anticipation of profits.

64. In *Gallagher v Jones*, Nolan LJ said at 140:

> "… The accepted qualification on the primacy of correct accountancy treatment has usually been described, as Pennycuick J described it, by saying that the treatment must comply with the statutory provisions. This, of course, reflects the fact that income tax is a creature of statute. But there are also references in the cases to income tax principles, such as Lord Reid's invocation … of the "non-statutory principle" that neither profit nor loss should be anticipated. With great respect I would suggest that this might equally be described as a restatement in a particular context of the statutory rule, in section 60 of the Income and Corporation Taxes Act 1988, that tax shall be charged "on the full amount of the profits or gains of the year" – no more and no less. But whatever the content of the expression "the principles of income tax law" may be I conclude, as did Pennycuick J, that the law does not enable or require us to ascertain the profit of a trade on a basis divorced from the principles of commercial accountancy."

65. As I have time and again emphasised, primacy of accounting principles only applies if those principles conform with the Ordinance. Under the principle of parliamentary supremacy, the legislature can make any law it pleases. It can make laws to tax on realised profits and, if it pleases, on unrealised profits as well. Tax is a creation of statute. While accountants are authorised to ascertain what are profits, which of those profits are chargeable to tax is a matter for the legislature and a matter for the court to interpret the intendment of the legislature. Thus, there can be no doubt that accounting treatments which are inconsistent with the statute are bound to be rejected or have to be modified. While Nolan LJ seemed to doubt if there are any non-statutory income tax principles, his Lordship did not expressly reject Lord Reid's principle that profits shall not be taxed until realised. His Lordship explained the decision in *Willingale* on the basis that the non-statutory principle referred therein was in fact a statutory one. Sir Thomas

Bingham MR also said at page 135 that the principle (which he called "the rule of non-anticipation") was squarely based on statutory provisions.

66. I would be very cautious before doubting any decision of the House of Lords. The principle was quoted by Lord Reid in *Duple Motor Bodies* in 1961, repeated in 1971 by his Lordship in *B.S.C. Footwear Ltd and Ridgway (Inspector of Taxes)* [1972] AC 544 and endorsed by Lord Morris of Borth-y-Gest at 560. Lord Reid said at 552:

> "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."

His Lordship expressly stated that the principle is a non-statutory principle. Then in 1977, Lord Salmon and Lord Fraser of Tullybelton in *Willingale* quoted Lord Reid's dicta without casting any doubt whatever on that non-statutory principle. I find it rather disingenuous for the Court of Appeal in *Gallagher v Jones* to attempt to explain *Willingale* on the basis of a statutory rule.

67. As tax is a creature of statute, it must be a principle of income tax law that no one shall be taxed unless authorised by law. It must necessarily follow that no profits shall be chargeable to tax unless and until such profits existed, were earned, or at least accrued. Of course, legislature can create tax on unrealised or even anticipated profits or income. Apparently, this is what the Commissioner is seeking to do in the instant case. I doubt if that was the Revenue's position in the United Kingdom at the time of the above decisions. In my view, the principle of no tax on profits unless realised, if not a principle of substantive law, must at least be a principle of construction of income tax statute. This is sufficient for me to dispose of the Commissioner's contention.

68. I have already held that the word "profits" in its ordinary sense includes advantages or benefits which are wide enough to include notional profits or book profits not actually realised. As Lord Oaksey put it, whether chargeable profits means real profits was all a matter of statutory construction. The word "trade" under section 14(1), as I have construed, could not have any other meaning than that ascribed to it by Lord Reid and Lord Wilberforce in *Ransom and Higgs*, i.e. buying and selling or exchange of commodities in a commercial transaction between two parties for profit. Section 14(1) imposes tax on profits arising in or derived from such trade, profession or business. The statutory intendment as ascertained from section 14(1) could not have been clearer. Applying the literal approach and this principle of construction, the words "profits" and "assessable profits" in section 14(1) must be construed to mean profits arising in or derived from commercial transactions, which of necessity means real profits from actual transactions and exclude anticipated profits or gains arising from revaluation of trading stock. This construction is also supported by the Inland Revenue Board of Review decisions in *D41/91*, *D47/91*, *Quitsubdue* and my conclusion reached in paragraph 55 above that in Hong Kong a person cannot trade with himself and make profits out of himself.

69. Mr Yuen SC submitted that bearing in mind section 19 of the Interpretation and General Clauses Ordinance, this Court is obliged to adopt a "fair, large and liberal construction and interpretation" of a statutory provision and to apply the presumption that an updating construction is to be given. Then, Mr Yuen SC submitted, applying this principle and bearing in mind the approach laid down in *Secan Ltd*, that the construction of section 14 should be updated along the approach adopted by the prevailing accounting standards, i.e. SSAP 24 and HKAS 39. He submitted that the changes introduced by these accounting standards demonstrated how the commercial world viewed the importance of taking into account the unrealised gains from revaluation of securities when computing profits and losses. He said that these changes make perfect sense since a company's true financial position cannot be ascertained without taking into account the change in value of the stock-in-trade. I am puzzled by his argument that *Secan Ltd*, SSAP 24 and HKAS 39 together could have the effect of giving the word "profits" in section 14(1) an updated construction as to include unrealised profits. Mr Yuen SC's submission is built on the principle that profits and losses have to be determined in accordance with ordinary commercial accounting principles and the effect of *Secan Ltd*. Then, Mr Yuen SC quoted extensively from *Secan Ltd* from 422 to 424 in which Lord Millett NPJ dealt with ascertainment of profits and losses in that case to support his proposition.

> "**The ascertainment of profits or losses**
> A trader's profits or losses must be ascertained separately for each year of account. For this purpose an account, customarily called a profit and loss account, is prepared in which the receipts and outgoings incurred during that year are entered. The expressions "receipts" and "outgoings" are somewhat misleading, for they are a relic of the days when accounts were drawn on a cash basis. In *Naval Colliery Co. Ltd v. C.I.R.* 12 TC 1017 at 1027 Rowlatt J observed:
>
> > "It is quite true and accurate to say, as Mr Maugham says, that receipts and expenditure require a little explanation. Receipts include debts due and they also include, at any rate in the case of a trader, goods in stock."
>
> Today the rule applies generally to every kind of trade, profession or business which draws its accounts on an accruals basis, and receipts include work in progress as well as goods held for sale. In what follows I shall use the expression "stock" to include not only property held for sale (i.e. completed flats awaiting a purchaser) but also work in progress (i.e. uncompleted parts of the development).
>
> The first step is to ascertain the trading profits or losses for the year. This is done by debiting the opening stock (which is a purchase from the previous year of account) and purchases during the year and crediting the closing stock (which is a sale to the next year of account) and sales made during the year. The balance represents the trading profit or loss for the year. The figures are sometimes entered directly in the profit and loss account ("above the line") and sometimes in a separate trading account with only the net balance taken to the

profit or loss account ("below the line"). Other receipts and outgoings, such as rents and interest receivable and payable, wages and salaries and office overheads, are then credited and debited in the profit and loss account. The balance represents the net profit or loss for the year and is taken to the balance sheet. Interest payable is normally treated as an overhead and debited below the line. When it is capitalised, however, it is treated as a purchase and debited above the line or in the separate trading account.

The need to enter the opening and closing stock is well established by the authorities: see *Whimster & Co. v. I.R.C.* (1925) 12 TC 813; *I.R.C. v. Cock Russell & Co. Ltd* (1949) 29 TC 387; *Patrick v. Broadstone Mills Ltd* (1953) 35 TC 44; *Duple Motor Bodies v. Ostime* (1961) 39 TC 537; *B.S.C. Footwear Ltd v. Ridgway* (1971) 47 TC 495; *Gallagher v. Jones* [1994] Ch 107. In *Duple Motor Bodies v. Ostime* at p. 569 Lord Reid explained:

> "It appears that at one time it was common to take no account of the stock-in-trade or work in progress for Income Tax purposes; but long ago it became customary to take account of stock-in-trade, and for a simple reason. If the amount of stock-in-trade has increased materially during the year, then in effect sums which would have gone to swell the year's profits are represented at the end of the year by tangible assets, the extra stock-in-trade which they have been spent to buy; and similar reasoning will apply if the amount of stock-in-trade has decreased. So to omit the stock-in-trade would give a false result. It then follows that some account must be taken of work in progress …".

In *Patrick v. Broadstone Mills Ltd* at p. 68 Singleton LJ laid it down as a general proposition that

> "You cannot arrive at the profits of the year without taking into account the value of the stock you have at the beginning of, and at the end of, the accounting year."

In *I.R.C. v. Cock Russell & Co. Ltd* at p. 392 Croom-Johnson J said:

> "There is nothing in the relevant legislation which indicates that in computing the profits and gains of a commercial concern the stock-in-trade at the start of the accounting period should be taken in and that the amount of the stock-in-trade at the end of the period should also be taken in. It would be fantastic not to do it; it would be utterly impossible accurately to assess profits and gains merely on a statement of receipts and payments or on the basis of turnover. It has long been recognised that the right method of assessing profits and gains is to take into account the value of the stock-in-trade at the beginning and the value of the stock-in-trade at the end as two of the items in the computation."

> On the taxpayer's behalf it was submitted that the purpose of entering the opening and closing stock is to ascertain the cost of sales and that there is no need to do so if there are no sales. I do not accept this proposition. The process is undertaken for the purpose of ascertaining the trading profits or losses for the year. The cost of sales is merely one element in the computation. But in any event there are always some sales, for the stock is carried forward in the balance sheet from year to year and is treated as a sale by one year to the next. But I can accept the taxpayer's argument to this extent, that if there are purchases during the year but no sales to third parties, the cost of the purchases (the debit) is normally matched by the increase in the value of the stock (the credit). Since the figures cancel each other out, they do not affect the profits or losses for the year. In these circumstances it does not matter whether they are entered and set off against each other in the profit and loss account itself or whether this is done in the trading account or elsewhere. This is merely a matter of presentation.
>
> Even more remarkably it was submitted on the taxpayer's behalf that if it is treated as having deducted interest in each of the first three years by setting it against the increase in the value of property under development then it cannot deduct it again from the sale proceeds in the current year. The argument is misconceived, and is based on a confusion between the *cost* of an asset (which is a debit) and its *value* (which is a credit). The fact that they may have the same monetary value does not mean that they are the same thing. When interest is capitalised it is treated as part of the *cost* of an asset. Since the asset is brought into the accounts at the lower of cost and net realisable value, both its *value* and its *cost* are increased by the same amount. There is thus no net impact on the profit and loss account. But the cost of the asset as well as its value is carried forward from year to year (hence the expression "the carrying amount") by the annual process to which I have already referred. In order to ascertain the profits or losses of each year of account separately, each year is treated as if it were a different trader. The *value* of the closing stock of one year is treated as sold to the next year and becomes the *cost* of purchasing the opening stock of that year. Any increase in the cost of an asset (including capitalised interest) debited in one year is set off against the corresponding increase in the value of the asset during that year, but the increased cost is carried forward to the following year and is ultimately available to be deducted from the sale proceeds. The effect of the process is not to allow the trader a double deduction, but to defer the deduction until the asset is realised by sale to a third party."

70. The gist of Mr Yuen SC's argument is that the use of the words "receipts" and "outgoings" are misleading nowadays as "receipts" include stock in trade. The old practice of assessing profits based on turnover was inappropriate. Profits for an accounting year cannot be properly ascertained without taking into account the value of stock at the beginning and end of the accounting year. A value has to be given to the stock in trade at the

beginning and end of each accounting year. Stock is carried forward in the balance sheet from year to year and treated as if it were a sale by the taxpayer of one accounting year to a different trader in the next accounting year. In this way, profits and losses can be anticipated. Hence, Mr Yuen SC submitted that the word "profits" in section 14(1) should be construed as including anticipated profits.

71. In reading *Secan Ltd*, it is important to bear in mind two things. Firstly, the profits in issue were real profits from actual sales. The dispute was how those profits were to be ascertained because there were two different accounting treatments as regards deduction of interest incurred in generating the profits. The focal point was accounting treatment of interest for the purpose of ascertaining profits and not what profits were chargeable to profits tax under the Ordinance. Secondly, the stock in trade in *Secan Ltd* was real property and not financial instruments. Though Lord Millett NPJ dismissed the taxpayer's argument that there was no need to take into account the opening and closing stock when there was no sale, his Lordship accepted it to the extent that if there were purchases during the year but no sales to third parties, the cost of the purchases would be matched by the increase in the value of the stock created by the purchases and the two figures cancel each other out occasioning no change in profits or losses for the year. As the stock in trade was real property, the reporting requirements under SSAP 24 and HKAS 39 do not apply. The taxpayer was free to value the stock at the lower of cost or market value, which was prudent accounting and consistent with ordinary commercial accounting principles. The profits in issue were real profits from actual sales. His Lordship was not addressing his mind to anticipated profits, which was not the issue in that case. There was no question of anticipated profits.

72. With respect, Mr Yuen SC was reading too much out of *Secan Ltd* which was not there. In *Secan Ltd*, the profits in question were real profits from actual trading transactions. The meaning of the word "profits" is not in issue. The focal point was on the accounting treatment of interest as an allowable deduction for the purpose of ascertaining profits chargeable to tax. It was in that context that Lord Millett NPJ held that the ordinary commercial accounting principles relating to treatment of interest did not require modification. That case was not about what profits were chargeable under the Ordinance. It did not have the effect of putting ordinary commercial accounting principles above the law. The jurisdiction to determine the question of what profits are chargeable to tax remains with the court. Lord Millett NPJ unequivocally reaffirmed the unshakable legal principle that ordinary commercial accounting principles have to be modified to conform with the Ordinance. Probably because the Commissioner and counsel ignored the difference in meaning of the terms "profits" and "assessable profits" under section 14(1) and that under ordinary commercial accounting principles, they mis-interpreted *Secan Ltd* or misunderstood its affect. In my view, updating of accounting practice could not have the effect of altering the principles of statutory construction or the meaning of the word "profits", unless those principles conform with the Ordinance. Were it otherwise, tax legislations could be changed by the accounting profession without legislative process. The court would be abdicating its judicial function in favour of the accounting profession. I am unable to see how the meaning of the word "profits" could have been changed by the combined effect of *Secan Ltd* and the introduction of SSAP 24 and HKAS 39.

73. Mr Yuen SC referred to *D35/86* 2 IRBRD 259 in which unrealised foreign exchange gains were held to be taxable. In that case, the taxpayer purchased Euro dollars using Hong Kong dollars to make short term deposits of one to six months. The deposits were rolled over on maturity. The taxpayer treated the deposits as trading transactions. He argued that profits arising from translation of the Euro dollars into Hong Kong dollars at the balance sheet date were not taxable as not having been realised upon maturity. The Inland Revenue Board of Review followed *Davies v The Shell Company of China, Ltd* (1951) 32 TC 133 and held that the full amount of principal and interest of the deposits should be brought into account. It said at 269:

> "… But there is authority for the proposition that where a trading transaction involves, as a necessary incident thereof, the purchase of a foreign currency, then any profit or loss resulting from an appreciation or depreciation of the foreign currency will prima facie be a trading profit or trading loss for income tax purposes as an integral part of the trading transaction. This was agreed by both parties as correctly stating the law in *Davies v The Shell Company of China, Ltd.* (1951) 32 TC 133, and was approved by Jenkins LJ in the same case where he says at 151, "That concession or admission (i.e., the proposition above stated) by Mr Grant (for the company) is amply justified by the cases to which we have been referred (i.e., *Lands Brothers v Simpson* 19 TC 62 and *Imperial Tobacco Company v Kelly* 25 TC 292)." The Taxpayer did not question the correctness of this principle. We see no reason why it should not apply to the present case."

74. That was a case in which the taxpayer used Hong Kong dollars to purchase Euro dollars to make the deposits. The taxpayer acknowledged that those were business or trading transactions. The repayment and interest were deemed accrued at balance sheet date. The taxpayer earned a right to payment of the same amount of Euro dollars plus agreed interest. The purchase of Euro dollars was a necessary part of the transaction. The profits in terms of interest were made and accrued. The question was how to value the fruit of the transactions. It was under those circumstances that unrealised exchange gains at balance sheet date were treated as profits. It is a common accounting practice in international banking that foreign currency assets are valued at the rate of exchange prevailing at the balance sheet date. This case can be easily explained on the basis that money, Euro dollars, is a fungible which must have a ready market and a value against the accounting currency, i.e. Hong Kong dollars. If an account has to be drawn up on a certain date, namely balance sheet date, the value of the Euro dollars must be that value which the Euro dollars have in the money market on that date. Properly understood, this was not a case of taxing on anticipated profits, but on actual accrued profits valued on balance sheet date. The decision in *D35/86* is one which is limited to foreign exchange gains and not of universal application.

75. Thus, adopting a literal approach to construction of section 14(1) and adopting the two principles of construction of income tax statutes, I reach the conclusion that the word "profits" in the expression "profits arising in or derived from Hong Kong … from

such trade, profession or business" in that section means real profits arising in or derived from actual buying and selling of commodities in commercial transactions between the taxpayer and his trading partners or supply of professional or other services by the taxpayer to another person and do not include notional or unrealised profits arising out of revaluation of the taxpayer's stock of trade.

Meaning of "assessable profits"

76. Having settled the meaning of the above terms, I now turn to construe the term "assessable profits". To ascertain "assessable profits", one starts with the definition in section 2 of the Ordinance which provides:

> "Assessable profits" means the profits in respect of which a person is chargeable to tax for the basis period for any year of assessment, calculated in accordance with the provisions of Part IV".

The term basically means profits chargeable to tax under section 14(1) as calculated in accordance with the various provisions under Part IV. The most relevant provision is section 16(1) which provides as follows:

> "In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period, including - …"

77. Thus, "assessable profits" means profits in the ordinary meaning of the word as understood in accordance with ordinary commercial accounting principles, as qualified by the term "arising in or derived from Hong Kong … from such trade, profession or business" as construed above and by taking into account the receipts under section 15 and deductions under section 16 and other provisions in the Ordinance, not otherwise taken into account under ordinary commercial accounting principles.

WHETHER WHAT THE TAXPAYER DID WAS WITHIN THE INTENDMENT OF SECTION 14(1)

78. There is no dispute that the Taxpayer did nothing but to hold onto the listed securities and draw up its financial statements in accordance with the prevailing accounting practice. The Taxpayer's contention is that it has done nothing to bring itself within the intendment of section 14(1). On the other hand, the Commissioner's contention are that, firstly, the Taxpayer is deemed to have traded with himself; and secondly, by drawing up its financial statement according to SSAP 24 and HKAS 39, which required gains arising from revaluation to be treated as profits, the Taxpayer is bound by its own election. On my construction of the terms "profits" and "assessable profits", the Commissioner's contention

must be rejected. The question is whether the Taxpayer has done anything to bring itself within the intendment of section 14(1).

79. Mr Yuen SC submitted that despite the listed securities were not sold, there was nevertheless profits, albeit unrealised, arising from trading. He argued that the Taxpayer is a company incorporated in Hong Kong and the listed securities were all listed in Hong Kong. The Taxpayer traded in the listed securities when it acquired them as part of its stock in trade. The listed securities appreciated in value and made gains arising in or derived from Hong Kong. Mr Yuen SC stopped short of arguing that the profits arose in or were derived from such trade in Hong Kong. That is precisely the fallacy in his argument. "Trade" as Lord Wilberforce and Lord Reid put it involved a trader selling something to another in a commercial transaction for reward. The act of acquisition of the listed securities without selling them to another cannot amount to "trade", nor is the fictitious sale of the acquired listed securities by the Taxpayer at the end of the accounting year to himself at the beginning of the next accounting year. Though the unrealised profits arising from revaluation between the opening and close of the accounting year were recorded as profits in accordance with prevailing accounting standards laid down in SSAP 24 and HKAS 39, the financial statements would have to be modified to conform with the Ordinance for profits tax purposes. That effectively means the unrealised profits will have to be removed or the listed securities re-valued at costs in accordance with ordinary accounting principles as if they were ordinary stock in trade.

80. Mr Yuen SC relied on dicta of Lord Millett NPC in *Secan Ltd* that losses are merely the mirror image of profits and must be ascertained for tax purposes in the like manner. He argued that there was no reason why profits could not be anticipated while losses could. In my view, the dicta of Lord Millett NPC represent a statement of general principle. A dichotomy in treatment between profits and losses has to be accepted, if the accounting principles applicable to treatment of profits require modification to conform with the Ordinance, while those applicable to treatment of losses do not. The word "profits" has a wide meaning under ordinary commercial accounting principles than that under section 14(1) as qualified by the expression "arising in or derived from Hong Kong … from such trade, profession or business". That qualification does not apply to the word "loss". The dichotomy has to be accepted. But insofar as real profits and real losses are concerned, there is no real dichotomy in treatment.

81. Mr Yuen SC suggested that it was unfair that the Taxpayer could have claimed the benefit of unrealised losses and then object to be charged profits tax on unrealised profits. There is no equity in a tax statute. But that apart, the unfairness is more apparent than real. There is in fact no unfairness in the tax regime or in the present case, if the ordinary commercial accounting principles are consistently applied in ascertaining profits and losses. The taxpayer's unrealised losses in an accounting year will result in a lower value of stock in trade in the beginning of the following accounting year. His opening stock will be valued at the lower of market value or cost at balance sheet date. The unrealised loss as such does not mean any actual monetary benefit in terms of a tax refund or cash. It is only a tax credit. If the taxpayer makes a profit, realised or unrealised does not matter, in the following accounting year, it will be set off against the unrealised loss of the previous year,

resulting in a reduced tax liability. If the profit is less than the loss in the previous year, his net loss will be carried forward, resulting in a reduced tax credit in his balance. If the profit is same as the loss in the previous year, the tax credit will be wholly set off resulting in no tax. If the accounting principles are consistently applied, the taxpayer's opening stock would be valued at the lower of the then market value and cost on previous year balance sheet date, which was market value and that included a built in loss. The actual profit he made out of his opening stock valued below his actual cost is just naught. He suffered no real loss, his tax credit is wholly set off and he pays no profits tax. Similarly, if he makes a profit more than his loss in the previous year, his tax credit will be wholly set off resulting in a reduced tax liability. In real term, he will be taxed on the surplus over and above his cost, nothing less. Under this tax regime, which does not pay a taxpayer for his loss, realised or unrealised, but gives him a tax credit to be applied to his future profits, there is no unfairness in allowing a taxpayer to claim unrealised losses and not to pay profits tax on unrealised profits.

82. It may be said that if these unrealised gains are not chargeable to profits tax, substantial revenue will be lost. On the other hand, it could equally and more forcefully be said that these profits were never made, not at least at the time of respective years of assessment. The Taxpayer has not actually made the profits to pay the profits tax thereon. It may even be forced to sell some of the listed securities to pay the profits tax. Ultimately, if the listed securities are sold, whether at a profit or at a loss, a proper tax assessment will be made. The unrealised profits, if actually made, will be appropriately charged to tax. If the Taxpayer is taxed on its unrealised profits but that amount of profits are never made, it will not be given a refund but will be issued a computation of loss, i.e. a tax credit, which, depending on its trading performance for the years that follow, may or may not be able to be used to set off against its future tax liability. It is fairer that the taxpayer should not be made to pay for profits he has not earned than to require him to pay first and get back a tax credit, not refund in cash, which he may or may not use to reduce his future tax liability.

83. On the facts of this case, the Taxpayer obtained no real monetary advantage in claiming unrealised losses and not paying tax on unrealised profits. For the year of assessment 1999/2000, it made a real profit of $14,584,250. It was able to claim deduction for dividends from listed shares and exempted interest tax of over $20 million, which resulted in a loss of $5,755,372, which was real loss. It did not get any refund of profits tax paid by the companies which listed securities it held or interest tax it paid.

84. In the subsequent years, following the adoption of SSAP 24 and HKAS 39, the Taxpayer incurred unrealised losses for which it was given tax credits. Again, it did not get any refund of tax paid in whatever form. The Taxpayer became profitable since the year of assessment 2003/04 based on realised and unrealised profits. The documents do not enable me to find out how much were its realised profits. But working on the basis of the scenario as pictured in paragraph 81 above, provided the accounting principles are consistently applied, the Taxpayer could be properly taxed on its real profits.

85. On the other hand, 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 Departmental Interpretation and Practice Notes No. 1 (Revised), the Commissioner also 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. These concessions are not statutory. Thus, the Commissioner is in effect charging profits tax on anticipate profits on one class of taxpayer and exempting the same from another two classes. Though there is no equity in a tax statute, a tax regime should not be applied so arbitrarily as to create such inconsistent results.

86. The Taxpayer has done nothing to attract liability to profits tax under section 14(1). It made no trading transactions from which the unrealised profits arose and it could not trade with itself. On the fact, not only was there no trading between the Taxpayer and a third party, there was no exchange, not even 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 selling them at undervalue. There was a total lack of commercial activity. I conclude that the unrealised profits recognised by SSAP 24 and HKAS 39 are not chargeable to profits tax under the Ordinance.

CONCLUSION

87. 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 buying or selling of commodities including listed securities or 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 if they have been received in cash; but do not include book or notional profits arising out of revaluation of trading stock.

88. The Taxpayer acquired listed securities as its trading stock. Some of those listed securities have not been sold. They appreciated in value. The change in value was recorded as profits in the Taxpayer's financial statements according to prevailing accounting standards, namely, SSAP 24 and HKAS 39. However, such profits were not real profits as they did not arise in or were derived from actual trading transactions. Those unrealised profits were outside the intendment of section 14(1) and were not chargeable to profits tax. Therefore, the accounting principles for ascertaining profits required to be modified to comply with section 14(1), so that the unrealised profits arising from revaluation of listed securities in accordance with SSAP 24 and HKAS 39 will have to be excluded from computation of profits tax. It is not unusual for companies to prepare two sets of accounts: one for its shareholders showing the real value of the companies as at balance sheet date in accordance with SSAP 24 and HKAS 39; and one for tax purposes showing the real profits chargeable to profits tax or losses for preparation of computation of loss.

89. Accordingly, this appeal is allowed with costs to the Appellant. Such costs are to be taxed, if not agreed. The Determination of the Respondent as well as the profits tax assessments for the years of assessment 2003/04 to 2005/06 are set aside.

(Anthony To)
Judge of the Court of First Instance
High Court

Mr Stewart K M Wong, instructed by Messrs Woo, Kwan, Lee & Lo, for the Appellant
Mr Rimsky Yuen SC, assigned by the Department of Justice, for the Respondent