CACV 135/2011

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF APPEAL
CIVIL APPEAL NO. 135 OF 2011
(ON APPEAL FROM HCIA NO. 8 OF 2007)

BETWEEN

NICE CHEER INVESTMENT LIMITED	Respondent
and	
COMMISSIONER OF INLAND REVENUE	Appellant

Before: Hon Cheung, Kwan and Fok JJA in Court
Date of Hearing: 22-23 May 2012
Date of Judgment: 19 June 2012

J U D G M E N T

Hon Cheung JA:

The Commissioner's Appeal

1. To J allowed an appeal by the taxpayer (respondent) against the determination by the Deputy Commissioner of Inland Revenue ('the Commissioner') (Appellant) which confirmed the assessor's assessment that the taxpayer is liable for profits tax for the years 2003/04, 2004/05 and 2005/06 in respect of unrealized gains. The Commissioner now appeals.

Background

2. The background of the case which is based on agreed facts can be summarised as follows:

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. In its profit and loss accounts for the years 1999/2000 to 2005/2006 the taxpayer recorded an item of net realised and unrealised gains or losses on trading investments/securities. The realised gain/loss is based on the disposal of trading investment/securities. The unrealised gain/loss is based on the changes in the fair value (i.e. quoted market price) of the unsold trading investments/securities held by the taxpayer during the relevant period. In computing the adjusted losses or assessable profits, the taxpayer excluded from assessment the unrealised gains for the years 2003/2004 ($456,060,896), 2004/2005 ($722,510,089) and 2005/2006 ($1,433,575,398) but claimed deduction of the unrealised losses (described in the profit and loss accounts as provision for diminution in value of listed investments held at year end) for 1999/2000, 2000/2001 ($352,858,935), 2001/2002 ($316,151,590) and 2002/2003 ($393,240,817).

5. The Commissioner was of the view that the unrealised gains and losses arising from revaluing the unsold trading investment/securities held at the year end should be included in the profits tax assessment for the year of assessment in which the unrealised gains were credited and 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 difference 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.

6. In the auditor's report accompanying the accounts submitted by the taxpayer in support of its profits tax returns, the auditor, PricewaterhouseCoopers ('Auditor') 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 Auditor 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.'

7. In the preparation of its accounts for the various financial years up to 31 March 2005, the taxpayer adopted ordinary commercial accounting principles and the 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.'

8. 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).'

Expert opinion

9. The Judge also summarised the evidence of the experts as follows:

' *The accounting experts' opinion*

8. There were no substantial disputes between the Taxpayer's accounting expert and the Commissioner's. There were no dispute 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.'

Basis of To J's judgment

10. The Judge held that the unrealised gains are not chargeable to profits tax on the following basis.

1) Profits under section 14(1) of the Inland Revenue Ordinance ('IRO') (Cap. 112) 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.

2) 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 facts, 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.

The Commissioner's approach

11. The Commissioner's case is a simple one, namely, the gains, although being unrealised, are profits of the taxpayer since the profits have been ascertained by reference to ordinary commercial accounting principles. Mr. Furness QC (together with Mr. Rimsky Yuen SC and Mr. Julian Lam) argued on behalf of the Commissioner that,

1) Following the approach mandated by the Court of Final Appeal in Commissioner of Inland Revenue v Secan Ltd. (2000) 3 HKCFAR 411 and on a true construction of section 14(1), the question of profits or losses must be ascertained by reference to ordinary commercial accounting principles unless the result is contrary to any statutory provisions in the IRO.

2) Accounting principles do not remain static. The relevant approach laid down in SSAP 24 and HKAS 39, as applied by the taxpayer in preparing its accounts in question, reflected the currently accepted means of ascertaining profits and is in no way contrary to section 14 of the IRO.

3) Contrary to To J's conclusion, a proper construction of section 14 of the IRO does not prevent the charging of profits tax in respect of unrealised gains arising from revaluation of the securities.

4) The supposed principle that profits must not be taxed unless they are 'actual commercial profits' has no statutory force and does not override the application of accounting principles. The same goes for the similar principle that profits can only be taxed when they are 'realised'.

5) The supposed principle that a man may not trade with himself is of no relevance to this appeal.

6) Accordingly, the gains arising from revaluation of the securities, albeit unrealised, are chargeable to profits tax under section 14 of the IRO. Any conclusion to the contrary would be inconsistent with the approach laid down in Secan Ltd.

Principles of commercial accounting

12. In Secan Ltd, Lord Millett NPJ, applying a long line of authorities, held at 419 that,

> ' ….. Section 14 imposes a charge to tax on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits therefrom "as ascertained in accordance with this Part [of the Ordinance]". Losses, of course, are merely the mirror image of profits, and must be ascertained for tax purposes in the like manner. 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.'

13. In the United Kingdom, this principle was recently reaffirmed by the House of Lords in Revenue and Customs Commissioners v William Grant & Sons Distillers Ltd [2007] 1 WLR 1448 at page 1458 per Lord Hope of Craighead who also adopted Sir Thomas Bingham MR's observation in Gallagher v Jones [1994] Ch 107 that the principles of commercial accountancy are not static but so long as they remain current and generally accepted they provide the surest guide to the question that the legislation requires to be answered.

14. In England, profits computed on an accounting basis which gives a true and fair view is now part of its statutory requirement. Lord Hoffmann in William Grant at 1458 stated that,

> ' 1 My Lords, the method of computing trading profits for the purposes of income and corporation tax has been settled for many years. First you compute the profits on a basis which gives a true and fair view of the taxpayer's profits or losses in the relevant period. Then you make any adjustments expressly required for tax purposes, such as adding back deductions which the taxing statute forbids. The classic formulation of this method is by Sir John Pennycuick V-C in Odeon Associated Theatres Ltd v Jones [1971] 1 WLR 442, 453-454 and it has now been codified in section 42(1) of the Finance Act 1998:
>
> > "For the purposes of Case I or II of Schedule D the profits of a trade, profession or vocation must be computed on an accounting basis

which gives a true and fair view, subject to any adjustment required or authorised by law in computing profits for those purposes." '

15. The reference to principles of commercial accounting can be shown at least from Whimster & Co v Inland Revenue Commissioners 1926 SC 20 where at page 25, Lord President Clyde held that,

> ' In computing the balance of profits and gains for the purposes of income tax, or for the purposes of excess profits duty, two general and fundamental commonplaces have always to be kept in mind. In the first place, the profits of any particular year or accounting period must be taken to consist of the difference between the receipts from the trade or business during such year or accounting period and the expenditure laid out to earn those receipts. In the second place, the account of profit and loss to be made up for the purpose of ascertaining that difference must be framed consistently with the ordinary principles of commercial accounting, so far as applicable, and in conformity with the rules of the Income Tax Act, or of that Act as modified by the provisions and schedules to the Acts regulating excess profits duty, as the case may be. For example, the ordinary principles of commercial accounting require that, in the profit and loss account of a merchant's or manufacturer's business, the value of the stock in trade at the beginning and at the end of the period covered by the account should be entered at cost or market price (whichever is the lower); although there is nothing about this in the taxing statutes.'

16. It is of note that the reliance on commercial accounting principles is subject to two equally important considerations:

1) Conformity with statutory provisions

17. 1) The principles of commercial accounting must be scrutinised by the courts and they must be in conformity with the provisions of the IRO.

2) Thus in Duple Motor Bodies Ltd v Ostime [1961] 1 WLR 739, Lord Reid at page 753 stated that

> ' Normally, a court attaches great weight to the view of the accountancy profession, though the court must always have the last word.'

3) Lord Denning in Heather v P-E Consulting Group Ltd [1973] Ch. 189 at 217 also stated that,

> ' The courts have always been assisted greatly by the evidence of accountants. Their practice should be given due weight. But the courts

have never regarded themselves as being bound by it. It would be wrong to do so. The question of what is capital and what is revenue is a question of law for the courts. They are not to be deflected from their true course by the evidence of accountants, however eminent.'

4) Sir John Pennycuik in Willingale v International Bank [1977] Ch 78 (Court of Appeal) at 97 stated that

'But it is likewise well established that the principles of commercial accountancy must yield not only to statutory provisions, in particular the prohibition of specified deductions, but also to any overriding principle of tax law.'

2) Profits must be earned

18. 1) Second, as stated in Whimster the profits of a trade are based on the difference between the receipts and expenditure laid out to earn those receipts in the period in question and the principles of commercial accounting are to be applied for the purpose of computing this difference. That there is a requirement for a receipt in the period in question in order to ascertain the profit can be found in the following authorities:

2) In The City of London Contract Corporation Ltd v Styles (1887) 2 TC 239 at 244, Esher MR held that,

'… the difference between the expenses necessary to earn the receipts of the year, and the receipts of the year are the profits of the business for the purpose of the income tax.'

3) In Russell v Aberdeen Town and County Bank (1888) 2 TC 321 at 327, Lord Herschell held that,

'……The profit of a trade or business is the surplus by which the receipts from the trade or business exceed the expenditure necessary for the purpose of earning those receipts. That seems to me to be the meaning of the word "profits" in relation to any trade or business. Unless and until you have ascertained that there is such a balance, nothing exists to which the name "profits" can properly be applied.'

4) In Gresham Life Assurance Society v Styles (1892) 3 TC 185 at 193, Lord Herschell held that

'It cannot, of course, be denied that, as a matter of business, profits are ascertained by setting against the income earned the cost of earning it,

nor that as a general rule, for the purpose of assessment to the income tax, profits are to be ascertained in the same way.'

5) In Westminster Bank Ltd v Osler (1932) 17 TC 381, the taxpayer converted one form of investment into another. It was held that the conversion was equivalent to the realisation of the investment and gains arising therefrom is subject to profits tax. Lord Hanworth MR (whose judgment was affirmed by the House of Lords) at 397 held that,

' "But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business. .... But it was said that the profit—if it was profit—was not realised profit, and, therefore, not taxable. I think the profit was realised. A profit is realised when the seller gets the price he has bargained for. No doubt here the price took the form of fully paid up shares in another company, but, if there can be no realised profit, except when that is paid in cash, the shares were realisable and could have been turned into cash, if the Appellants had been pleased to do so. I cannot think that Income Tax is due or not according to the manner in which the person making the profit pleases to deal with it." '

6) In Tennant and Smith [1892] AC 150 at 164, Lord Macnaghten held that,

' ……It is a tax on income in the proper sense of the word. It is a tax on what "comes in" —on actual receipts.'

Profits to be ascertained and earned

19. 1) However it is important to recognize that a charge to profits tax is no longer confined to cash receipts but also to profits that have been ascertained and earned. Hence Lord Diplock in Willingale [1978] AC 834 (House of Lords) at 841 stated that,

' It is well settled by the authorities cited by my noble and learned friends that a profit may not be taxed until it is realised. This does not mean until it has been received in cash but it does mean until it has been ascertained and earned. It follows in my view that corporation tax cannot be levied in respect of the bank's transactions until the fiscal year in which the bank sells the bill or if the bank holds it until maturity, until the fiscal year in which it matures. The tax is leviable even if the bank does not receive the cash in that fiscal year. If the bank's customer defaults, an adjustment would be made for the bad debt in the following year.'

2) Lord Millett in Secan Ltd reaffirmed this approach at page 422 that:

> ‘ 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 (1897) Ltd v IRC 12 TC 1017 at p.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 (ie completed flats awaiting a purchaser) but also work in progress (ie uncompleted parts of the development).’

3) Ormrod LJ in Willingale (Court of Appeal) at page 92-93 elaborated how the earning basis is to be reconciled with the cardinal rule of taxation that ‘profit shall not be taxed until realised’ or sometimes expressed as ‘neither profits nor losses may for tax purposes be "anticipated"’.

> ‘ ……"Realised" cannot, therefore, be the equivalent of "received"; for the purposes of the rule this profit must be regarded as "realised" when the contract of sale is made; that is, when the goods are replaced in the taxpayer's books by a debt. In the case of work or services, the value of the work must be brought into the accounts for the year in which the work is done, or the services rendered, but, presumably, only if the taxpayer has completed the work, or done enough under the contract to entitle him in law to receive payment at some future time. If this reasoning is correct the profit is realised when the taxpayer becomes legally entitled to payment, either immediately or at some future date. It seems to me, although I may be wrong, that only in this way can the earnings basis of assessment be reconciled with the cardinal rule.’

4) Likewise Sir John Pennycuick at page 95 stated that,

> '……The basic scheme of tax law is that income is taxable when received. To quote the well-known aphorism of Rowlatt J. in Leigh v. Inland Revenue Commissioners [1928] 1 K.B. 73 (a different context), "Receivability without receipt is nothing." And for a general statement see Simon's Taxes, 3rd ed. (1976), vol. A, p. 118. It is of course true that in many sets of circumstances a profit is brought into charge under Case I or Case II of Schedule D in the year in which it is earned, although the consideration is not received in that year, for example the simple case where goods are sold in consideration of a deferred payment. In such a case the payment is related back to the year of sale. But it is quite a different matter to bring into charge as an immediate profit an unrealised accrual in value, however likely it may be, having regard to the nature of the asset, that its realisation will ultimately produce a corresponding profit.'

My view

Statutory interpretation

20. 1) With a recognition of these principles, I will set forth my view on the Commissioner's appeal.

2) In this case the Commissioner charged profits tax in respect of the gains arising from the fluctuation in the fair value of the stock-in-trade of the taxpayer, namely, trading investment/ securities. The specific type of investment/securities which attracts the provision for unrealised gain or loss is described as 'other investments' which are to be distinguished from 'investment securities' and 'held to maturity securities'. It is an agreed fact that the securities in question are held for trading purposes. The Court is not concerned with conflicting accounting standards. The issue in this appeal is whether the unrealised gains are profits liable to be charged for profits tax. This is entirely a matter of statutory interpretation. As Lord Millett NPJ observed in Collector of Stamp Revenue v. Arrowtown Assets Ltd (2003) 6 HKCFAR at 536 that,

> 'The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.'

3) In my view the Judge is correct in holding that the unrealised gains are not chargeable as profits.

Traditional valuation of stock-in-trade

21. 1) Traditionally stock-in-trade and work in progress have been valued at cost or lower market value. In Duple Motor Bodies Limited v. Ostime [1961] 1 WLR 739 Lord Reid at 751 explained that,

‘…. It appears that at one time it was common to take no account of 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 stock-in-trade would give a false result.

….

Then the question is what figure should be taken to represent the stock-in-trade. If it consists of articles bought for resale the answer is obvious—the price the taxpayer paid for them or their cost to him. If market value were taken that would generally include an element of profit, and it is a cardinal principle that profit shall not be taxed until realised : if the market value fell before the article was sold the profit might never be realised. But an exception seems to have been recognized for a very long time: if market value has already fallen before the date of valuation so that at that date the market value of the article is less than it cost the taxpayer, then the taxpayer can bring the article in at market value, and in this way anticipate the loss which he will probably incur when he comes to sell it. That is no doubt good conservative accountancy but it is quite illogical. The fact that it has always been recognised as legitimate is only one instance going to show that these matters cannot be settled by any hard-and-fast rule or strictly logical principle.’

2) In BSC Footwear Ltd v Ridgway [1972] AC 544 Lord Reid at 552 H – 553 C stated that,

‘ This principle [i.e. neither profit nor loss can be anticipated] is subject to an exception as regards stock-in-trade. If it were applied logically, stock-in-trade must always be valued at the end of the year at cost, even if it could have been bought at the end of the year much more cheaply. But for half a century at least traders have been allowed to value such stock at the end of the year at its market price or market value at that date if that is lower than the original cost price: on the other hand, the trader is

not required to value his stock at market value if that is higher than the original cost. So to this extent he can diminish his profit in year one by setting against it an anticipated loss in year two. It is only an anticipated loss because the market price may move upwards before he sells the stock so that when he does sell it he gets a price equal to or greater than the original cost and so never in fact suffers any loss. If that happens the matter is put right in year two. The effect of carrying forward the stock at a valuation below cost is that in the account for year two that valuation and not the actual original cost is deemed to be the cost, and so the profit in year two is increased.

That exception has been expressed by the phrase "cost or market value, whichever is the lower." But that is only a shorthand convenient form of expression. It is not contended by the Crown that it is a rule of law to be interpreted as if the words occurred in a statute. It is I think accurate and adequate where there is a market in the ordinary sense.'

3) To value trading investment/securities on their fair value is unique to the securities trade. It is not necessary to address in this appeal whether the traditional valuation method of stock-in-trade should be preferred to the fair value method in trading investment/securities. The practice for enterprises to include in the notes to the financial statements the market values of the trading investments on balance sheet date is to enable the users of the statements to have a clearer view of the value of these investments and thus the true worth of that enterprise in terms of the factors outlined in the Framework for the Preparation and Presentation of Financial Statements ('Framework') issued in June 1997 by the HKICPA, namely, the financial position, performance and changes in financial position of the entity.

4) The financial position of an entity is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. Information about the economic resources controlled by the entity and its capacity in the past to modify these resources is useful in predicting the ability of the entity to generate cash and cash equivalents in the future. Information about the performance of an entity, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future. Information concerning changes in the financial position of an entity is useful in order to assess its investing, financing and operating activities during the reporting period. Information about financial position is primarily provided in a balance sheet. Information about performance is primarily provided in an income statement. Information about changes in financial position is provided in the financial statements by means of a

separate statement.

5) In my view the fact that the financial statement should reflect the fluctuation in the fair value of these trading investment/securities and the fact the fluctuation is described as unrealised gains/losses do not mean that unrealised gains are 'profits' for the purpose of the IRO. There is clearly a difference between what is required by way of accounting standards in a financial statement so that a full picture may be presented on the financial position of the company and what is profit for the purpose of profits tax under the IRO. As Lord Radcliffe observed in Southern Railway of Peru Ltd v Owen [1957] AC 334 at 360:

'All this is very important, because, of course, accountants are very specially concerned with the problems that attend the true ascertainment of a year's profit and the establishment of techniques that assist in this. But, for all that, there is nothing in the case that seems to me to fix on the point that is really the heart of this appeal. The requirements that an auditor may make before signing a balance sheet (I assume that the words used in the case are meant to cover the statutory reference to the profit and loss account) do, no doubt, cover his opinion that that account gives a "true and fair view" of the profit for the financial year, but I do not think that such requirements are necessarily the same thing as the auditor's opinion that some particular provision could not be omitted without compromising the true and fair view. It is not possible completely to equate the balance shown by a company's profit and loss account with the balance of profit arising from the trade for the year.'

Intent of the IRO

22. 1) Earlier, I have referred to authorities which established that profits must be received, accrued or earned. This is in accordance with the structure and intent of the provisions for profits tax under Part IV of the IRO. Section 14(1) provides that

'14(1) 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.'

2) Although the definition in section 2 of the IRO of 'assessable profits', namely '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' does not carry the matter further, the words 'arising in or derived from' the trade support the view held in the authorities that there must be a receipt, an accrual or earning before you can talk about a profit.

3) Section 14A of the IRO lends credence to this view. It deals with profits tax charged on interest and gains on debt instruments which were 'received by or accrued to' the taxpayer. The same requirement must be present in the principal section of section 14.

' 14A(1) For the purposes of this Part the assessable profits of a person for sums received by or accrued to the person as—

(a) interest paid or payable on a medium term debt instrument; and

(b) any gain or profit on the sale or other disposal or on the redemption on maturity or presentment of the medium term debt instrument,

are chargeable to tax under this Part at one-half of the rate specified in Schedule 1 or Schedule 8, as the case may be.' (emphasis added)

4) Section 15 which deems certain income as trading receipts again uses the same words which support the requirement of a receipt for the purpose of profits tax assessment. Sums 'received by or accrued to' the taxpayer are deemed to be 'receipts arising in or derived from' the trade. Again this must be a reference back to the principal section. Just to take one example set out in section 15(1):

' 15(1) For the purposes of this Ordinance, the sums described in the following paragraphs shall be deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong—

(a) sums, not otherwise chargeable to tax under this Part, received by or accrued to a person from the exhibition or use in Hong Kong of cinematograph or television film or tape, any sound recording, or any advertising material connected with such film, tape or recording.' (emphasis added)

5) Section 15A which deals with another deeming provision in respect of the transfer of the right to receive income from property, likewise used the words 'trading receipt arising in or derived from Hong Kong'.

' 15A(1) Subject to subsection (3) where —

(a) a right to receive income from property is transferred by a person to another person; and

(b) consideration has been received or is receivable in respect of the transfer,

the amount of the consideration shall, notwithstanding the exclusion relating to the sale of capital assets contained in section 14, be treated as a trading receipt arising in or derived from Hong Kong by the transferor from a trade, profession or business carried on in Hong Kong.' (emphasis added)

6) In addition to the requirement of a receipt, the taxpayer must be also allowed to deduct the expenditure that has to be incurred in generating the receipt before there is a profit arising from or derived from trade. This is provided for by section 16 of the IRO.

' 16(1) 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—…….'

7) Section 17 disallows certain types of deduction for the purpose of ascertaining profits. Again this illustrates the requirement of a receipt and deduction for the purpose of arriving at a profit.

8) Section 18B deals with the basis for computing assessable profits for years of assessment commencing on 1 April 1975. The terms 'arising in or derived from Hong Kong' are used.

9) Section 19C allows a taxpayer to carry forward his loss in a year of assessment against the amount of assessable profits for subsequent years of assessment. As accepted by the Commissioner during the hearing the taxpayer will be taxed on the unrealised gains which may never materialise if the taxpayer sold the investments in the next year at a loss. Further the taxpayer could not carry forward the loss if he ceased trading in the next year. This highlighted the hardship faced by the taxpayer.

Profits must be realised and not anticipated

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

2) This is best illustrated by what Lord Fraser of Tullybelton held in Willingale (House of Lords) at 843:

‘ It is well established that “the question of what is or is not profit or gain must primarily be one of fact, and of fact to be ascertained by the tests applied in ordinary business”—Sun Insurance Office v. Clark [1912] A.C. 443, 455 per Viscount Haldane. But that general rule is subject to the exception that where ordinary commercial principles run counter to the principles of income tax they must yield to the latter when computing profits or gains for tax purposes. In B.S.C. Footwear Ltd. v. Ridgway [1972] A.C. 544, 552G Lord Reid said:

> “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. A trader may have made such a good contract in year one that it is virtually certain to produce a large profit in year two. But he cannot be required to pay tax on that profit until it actually accrues.”

Lord Morris of Borth-y-Gest at p. 560E quoted from the speech of Lord Reid in Duple Motor Bodies Ltd. v. Inland Revenue Commissioners [1961] 1 W.L.R. 739, 751 the statement that “…. it is a cardinal principle that profit shall not be taxed until realised.” ’

3) Mr. Furness’s response to this and other similar statements is simply that later authorities showed that commercial accounting principles are the best guide to allocate profit or loss.

4) I disagree. Secan Ltd certainly does not touch on the issue that is now under discussion. In that case the issue is whether interest charges from borrowing which had been capitalised by the taxpayer and treated as the costs of its stock-in-trade (property under development) in past accounting years can be used subsequently as deductions from the sale of the stock-in-trade (property developed and sold). The capitalisation of interest was done in accordance with acceptable accounting practice.

The stock-in-trade was valued at costs or net realisable value. Lord Millett NPJ held at 425G that:

‘ In my judgment the taxpayer’s accounts in each of the first three years of trading were properly prepared in accordance with ordinary accounting principles and in conformity with the Ordinance and showed a true and fair view of the taxpayer’s losses. In the computation of these losses interest was properly deducted by being debited and then set off against the corresponding increase in the value of property under development. The taxpayer now claims to bring forward losses which, because it capitalised the interest, it did not sustain. These fictitious losses arise from double counting. The process involves charging the interest to the development cost account in order to prevent the increased value of property under development creating a trading profit for the year to be carried into the profit and loss account, and at the same time charging it to the profit and loss account in order to increase the loss for the year.’

5) He explained at 425B why there was double counting:

‘ The cost of the development is a debit: “property under development” in the balance sheet is an asset. Accountants do not possess a philosopher’s stone which can turn a debit into an asset. The figure which Mr Fong Hup took from the development cost account represented the cost of the development; the figure which he entered in the balance sheet represented the value of the development. In the process he must be taken mentally to have set them off against each other, and because they cancelled each other out there was no net balance to bring into the profit and loss account.’

6) Apart from the affirmation of the principle that profits are to be ascertained according to commercial accounting principles, I do not see how Secan Ltd can assist the Commissioner.

7) The statement quoted earlier of Lord Hoffmann in William Grant Ltd also does not in any way lessen the force of Lord Fraser’s view in Willingale. Neither does the view of Lord Hoffmann at page 453 of William Grant Ltd, namely,

‘ 15. Submissions that accounts must comply with fundamental principles of accounting additional to the best practice of accountants as embodied in the accounting standards have been made in other cases. But they have always been rejected. In Odeon Associated Theatres Ltd v Jones [I971] 1 WLR 442, 454 Sir John Pennycuick V-C described the argument as “entirely novel”. It was rejected by the Court of Appeal in Gallagher v

Jones [1994] Ch 107. In this case, it takes the form of saying that profits must be ascertained by taking all the revenue received during the year, deducting all the costs (including depreciation) incurred during the year and making an adjustment for the difference between opening and closing stocks, treating an increase in stock value as if it was revenue. That is certainly one way of computing profits and there are dicta in earlier cases which show that half a century ago and more, judges and accountants thought it was the normal and obvious way of computing profits. It may have been the only practical method when record-keeping was not sufficiently sophisticated to enable one to make a meaningful attribution of costs in one year to sales in some future year. It is not, however, the philosophy of SSAP 9, which permits the cost of unsold stock to be carried over into future years and set against future sales. In this exercise, relevant depreciation is simply another cost.'

8) In that case the House of Lords upheld the taxpayer's method of computing profit for the purpose of tax which was in accordance with the best practice of accountants. It is important to bear in mind the context in which the principle is stated. The head note summarised the facts of the case as follows:

' In their profit and loss accounts for the years in question, which were prepared in accordance with current accounting standards, the taxpayer companies made deductions for the depreciation of fixed assets by dividing the depreciation occurring during the year shown in the balance sheet or carried in the opening stock figure into two parts, the first being the depreciation in fixed assets that related to the production of goods sold during the year or in assets not used for production, the second being that which related to the production of unsold stock. … In making their tax computations the companies deducted the first element of depreciation from the year's revenue and carried the second element forward as part of the cost of unsold stocks on the basis that the amount of depreciation to be added back to the accounting profit for corporation tax purposes pursuant to section 74(1)(f) of the Income and Corporation Taxes Act 1988 did not include the amount of the charge for depreciation represented in the profit and loss account as depreciation in stock. The revenue initially accepted that method of computation, but subsequently it took the view that the amount of depreciation added back in a given year should be the gross amount of depreciation charged in that year and accordingly disallowed as a deduction for corporation tax purposes sums representing the difference between the amount of depreciation used in the calculation of the figure for the stock brought forward and sold during that year and that used in the calculation of the

figure for the stock held at the end of the period and carried forward.'

9) In this case, the issue is not whether there are 'fundamental principles of accounting in addition to the best practice of accountants as embodied in the accounting standards'. The fundamental issue here is whether the accounting standards are in conformity with the statutory provisions for profits tax. In my view they are not for the same reason identified by the House of Lords in Willingale and B.S.C. Footwear Ltd, namely, the Commissioner charged profits tax on unrealised gains. It anticipated the profit of the taxpayer. In the words of Lord Fraser in Willingale at 847,

> ' For these reasons I am of opinion that the bank's accounts prepared for commercial purposes are drawn up on the principle of anticipating future profits from its holding of bills and notes. There are no doubt excellent commercial reasons for preparing the accounts in that way; if I may borrow the words of Walton J. [1976] 1 W.L.R. 657, 663C, they
>
> > " are much better economic indicators than corporation tax accounts would be as to whether a bank is or is not doing what it ought to be doing, that is to say, steadily making an economic profit for its shareholders."
>
> But they are not a proper basis for assessing the bank's liability to corporation tax.'

10) In this case since there was no realisation of the trading investment/securities, there was no profit arising from the trading of these assets which may be charged to profits tax. Even though stock-in-trade is treated as a receipt, the traditional approach is to adopt a prudent measure in its valuation. I am not convinced that current accounting practice, laudable it may be, can achieve such a quantum leap by turning unrealised gains of these financial stock-in-trades into profits for the purpose of taxation.

11) Further, I do not see why the unrealised gains of stocks-in-trade in financial trades should be singled out as profits for the purpose of taxation. After all section 14 charges tax on profits on 'every person' carrying on a trade. The question of fairness becomes relevant.

12) The Commissioner relied on the Board of Review Case No. D35/86 in support of the argument that profits tax was charged on unrealised gain. This is wrong. Properly understood, in that case there was a realised gain when its assets were changed from one currency to another.

13) 1) The Commissioner also relied on Accounting Bulletin 4 entitled 'Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Hong Kong Companies Ordinance' issued by HKICPA which stated at paragraph 3.3 that

'3.3. It is generally accepted that profits shall be treated as realised for the purpose of applying the definition of realised profits in companies legislation only when realised in the form of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty. In this context, "realised" may also encompass profits relating to assets that are readily realisable. This would embrace profits and losses resulting from the recognition of changes in fair values, in accordance with relevant accounting standards, to the extent that they are readily convertible to cash.'

2) Irrespective of the view expressed in the Bulletin, the issue of whether unrealised gains are profits is ultimately one of statutory interpretation.

Judge made rules

24. 1) Mr. Furness criticised the Judge for relying on judge-made rules instead of accounting principles. Mr. Furness relied on the judgment of Sir Thomas Bingham MR in Gallaher v. Jones (Inspector of Taxes) [1994] Ch. 107 at 134 that:

'The authorities do not persuade me that there is any rule of law such as that for which the taxpayers contend and the judge found. 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.'

2) See also Johnston v Britannia Airways Ltd [1994] STC 763 at page 782 and Herbert Smith v Honour [1999] STC 173 at page 203.

3) It is important to note that Sir Thomas Bingham only deprecated judge-made rules which override commercial accounting principles when it was not shown that such principles were inapt to determine the true profits or losses of the business. It cannot be a general criticism of all the judge-made rules which are consistent with the statutory provisions in the first place. Realistically, the so-called judge-made

rules are short-hand expressions used by the Courts in its interpretation of statutory provisions.

Gain and loss

25. 1) It is necessary to address the argument that losses are the minor image of gains and must be ascertained for tax purposes in the like manner. Lord Millett has said this in Secan Ltd at page 419C. Section 19D of the IRO confirmed that the amount of loss must be computed in like manner and for such basis period as the assessable profit for that year of assessment would have been computed. It is argued that in the same way as accounting principles required the valuation of stock-in-trade at the lower of cost or market value, they now require the inclusion of gains arising from the revaluation of trading securities to produce a clearer view of their value and true worth.

2) Indeed as Mr. Goldberg QC (appearing with Mr Stewart Wong SC for the taxpayer) submitted, it would be very odd if a rule about how a loss is to be computed had the effect of creating a profit from the holding of an asset. I agree with Mr. Goldberg's analysis that there is no conflict between the consequences of the rule. So far as losses are concerned, the consequence of the cost or lower market value rule is that losses are relieved when stock falls in value. The loss is an aspect of the cost of an asset which is actually incurred by the act of purchase whereas a profit is earned by an act of disposition which has not happened at all in this case. So far as profits are concerned, the consequence of the rule is that, as stock is never brought in at more than market value, gains are not recognised as stock increases in value. Put in another way, a loss is recognised as it is suffered by reference to an undertaken transaction: a gain is recognised only when a transaction which earns and realises it occurs so that losses and profits are, indeed, computed in like manner as required by section 19D.

3) This analysis provides a reasoned answer to Lord Reid's statement in Duple Motor that the traditional valuation of stock-in-trade at the lower of costs or market value is illogical. This reasoned response is preferred to the one suggested by Mr. Furness, namely, that it is not illogical simply because of commercial accounting principles.

4) It is also suggested that the taxpayer had availed itself of the unrealised loss by seeking deduction of those losses. As can be seen from the extracts of the profit and loss accounts referred to in the agreed facts, the taxpayer had in fact reinstated the deducted losses in subsequent years. This is described in the profit and loss account as 'provision for diminution in value of listed investments held at year end written back'

for 2003-2004 ($794,224,095) and 2005-2006 ($212,619,866). This is approximately the same amount that had been deducted in earlier years. In any event, Mr. Furness had not really explained how the taxpayer's treatment of the unrealised loss would affect its challenge on the unrealised gains.

Trade

26. 1) Mr. Furness also argued since the taxpayer carried on trade, the requirement of trade is satisfied. In Ransom v Higgs [1974] 1 WLR 1594 at 1611, Lord Wilberforce held that:

> '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. Trade, moreover, presupposes a customer (to this too there may be exceptions, but such is the norm), or, as it may be expressed, trade must be bilateral—you must trade with someone. The "mutuality" cases are based in part at least upon this principle, and it was the existence of it that made Sharkey v. Werner [1956] A.C. 58 an interesting problem: could Lady Zia trade with herself?'

2) The focus in this appeal must be on those trading investment/securities which were retained by the taxpayers and not transacted. For the purpose of this appeal it is not necessary to discuss the application of the principle discussed in Sharkey v Werner [1956] AC 58 and Commissioner of Inland Revenue v. Quitsubdue Ltd [1999] 2 HKLRD 481.

Others

27. Both parties have identified many issues and referred extensively to cases in support of their positions. I have chosen to focus my judgment on the issues that are determinative of the appeal.

Conclusion

28. I would thus dismiss the appeal on the basis that the Commissioner's profits tax assessments for the years of assessment 2003/04 to 2005/06 cannot stand and must be adjusted to coincide with the taxpayer's original tax computations. I would also order on a provisional basis that the taxpayer should have the costs of the appeal.

29. It remains for me to express my indebtedness to counsel on both sides for their invaluable assistance.

Hon Hartmann JA:

30. I have had the benefit of reading the judgment of Cheung JA in draft and agree with it.

Hon Fok JA:

31. I agree with the judgment of Cheung JA, which I have had the benefit of reading in draft.

(Peter Cheung)	(M. J. Hartmann)	(Joseph Fok)
Justice of Appeal	Justice of Appeal	Justice of Appeal

Mr Michael Furness QC, Mr Rimsky Yuen SC and Mr Julian Lam, instructed by Department of Justice, for the Appellant

Mr David Goldberg QC and Mr Stewart Wong SC, instructed by Woo, Kwan, Lee & Lo, for the Respondent