FACV No. 23 of 2012

IN THE COURT OF FINAL APPEAL OF THE HONG KONG SPECIAL ADMINISTRATIVE REGION
FINAL APPEAL NO. 23 OF 2012 (CIVIL)
(ON APPEAL FROM CACV NO. 135 OF 2011)

Between

NICE CHEER INVESTMENT LIMITED **Respondent**

and

COMMISSIONER OF INLAND REVENUE **Appellant**

Court:	Chief Justice Ma, Mr Justice Ribeiro PJ, Mr Justice Tang PJ, Mr Justice Litton NPJ and Lord Millett PJ
Dates of Hearing:	16 – 17 October 2013
Date of Judgment:	12 November 2013

J U D G M E N T

Chief Justice Ma:

1. I agree with the judgment of Lord Millett NPJ.

Mr Justice Ribeiro PJ:

2. I agree with the judgment of Lord Millett NPJ.

Mr Justice Tang PJ:

3. I am in full and respectful agreement with the judgment of Lord Millett NPJ which I have read in draft. There is nothing I can usefully add.

Mr Justice Litton NPJ:

4. I agree with the judgment of Lord Millett NPJ.

Lord Millett NPJ:

5. The question for decision in this appeal is whether the introduction of new accounting standards in Hong Kong in 1998 had the effect of making unrealised increases in the value of the Respondent's trading stock held at the end of its accounting period chargeable for the first time as taxable profits.

6. The appeal is brought by the Commissioner of Inland Revenue ("the Commissioner") from a judgment dated 19 June 2012 of the Court of Appeal (Cheung, Hartmann and Fok JJA) dismissing its appeal from a judgment of To J dated 28 June 2011. By his judgment To J had held that the introduction of the new accounting standards did not have the effect for which the Commissioner contended and allowed the Respondent's appeal from assessments to profits tax in each of the three years from 2003/04 to 2005/06.

The facts

7. The facts which are agreed are set out at length in the judgments below and it is not necessary to repeat them. They may be shortly stated as follows.

8. The Respondent is a private company incorporated in Hong Kong. Its principal business consists of trading in marketable securities quoted in Hong Kong. Prior to the introduction of new accounting standards for 1999 and subsequent years, its trading stock like that of other traders and in accordance with the conventional practice was shown in its financial statements at the lower of cost and net realisable value. This had the effect that unrealised increases in the value of its trading stock during the accounting period (in the Respondent's case marketable securities held for sale) were not reflected in its profit and loss accounts or tax computations. Following the introduction of new accounting standards in 1998, however, the Respondent duly recorded in its profit and loss accounts not only profits and losses which it had realised by the sale or disposal of trading stock during the accounting period but also changes in the value of unrealised trading stock held at the end of the period.

9. There is no dispute that the Respondent's financial statements for the relevant accounting periods were prepared in accordance with the prevailing albeit new accounting practice in Hong Kong. The Respondent accepts (and its auditors reported) that its financial

statements were prepared in accordance with accounting principles generally accepted in Hong Kong and showed a true and fair view of its affairs and of its profits and losses for the relevant accounting periods. But it contends that its profit and loss accounts need to be adjusted for tax purposes by excluding unrealised profits from its tax computations since they are not assessable to profits tax. Accordingly in computing its assessable profits and allowable losses for tax purposes for each of the years from 2003/2004 to 2005/2006, the Respondent excluded unrealised profits (ie increases in value of its unrealised trading stock during the accounting period) but continued to claim to deduct unrealised losses which it described in its profit and loss accounts as provision for the diminution in value of listed investments held at the end of the accounting period.

10. The Commissioner considered that the unrealised gains and losses arising from revaluing the trading stock held at the end of the year 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 Respondent's financial statements. Accordingly, he assessed the Respondent to profits tax on the basis of the realised and unrealised losses for the years of assessment 1999/2000 to 2002/03 and profits for the years of assessment 2003/04 to 2005/06. The difference between the amount of the profits tax assessed on this basis over the period and that calculated by the Respondent is of the order of $250 million.

11. The new accounting standards in accordance with which the Respondent's financial statements were prepared are applicable only to persons who carry on the business of trading in marketable securities, whether listed or not, and while mandatory in other cases are optional in the case of small and medium sized businesses. As the Court of Appeal observed, the surprising effect of the Commissioner's contentions is that, without any statutory support in the taxing statute, taxpayers who carry on the business of trading in securities are taxable on their unrealised profits while those who carry on other businesses are not; and unlike larger businesses carrying on the same trade small and medium sized businesses may choose whether or not to be taxed on their unrealised profits. In my judgment, as will shortly appear, this is not merely surprising; it is also contrary to the express charging provisions for profits tax in Hong Kong.

The statutory provisions

12. Section 14(1) of the Inland Revenue Ordinance, Cap 112 ("the Ordinance"), imposes a charge to profits tax

> "… for each year of assessment … 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 … as ascertained in accordance with this Part." (emphasis added)

Section 2 defines "assessable profits" 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 4"

Section 18B(1) provides that, for the relevant years of assessment

> "the assessable profits for any year of assessment … from any trade, profession or business carried on in Hong Kong shall be computed on the full amount of the profits *therefrom* arising in or derived from Hong Kong during the year of assessment." (my emphasis)

13. The question for decision, therefore, is whether for the purpose of profits tax unrealised increases in the value of trading stock held at the end of the accounting period as a result of the revaluation should be included in the computation of "the full amount of the profits … arising in or derived from Hong Kong during the year[s] of assessment". As the Courts below observed, this raises a matter of statutory construction[1], not accounting practice. The question is one of law: what does the statute mean by the words "the full amount of the profits therefrom during the year of assessment"? Whatever these words mean, the fact that they apply to "every person" means that in the absence of some statutory provision to the contrary they mean the same for every taxpayer to which the Ordinance applies whatever the nature or size of his business. Moreover, the word "therefrom" (meaning from any trade, profession or business) suggests that the profit must derive from some trade, professional or business activity and not merely be the result of a revaluation of assets held for the purpose of the trade, profession or business.

The Commissioner's case

14. At the heart of the Commissioner's case lay three propositions. First, the word "profits" is not defined in the Ordinance, and in the natural and ordinary meaning of the word unrealised profits are nonetheless profits. Secondly, the amount of the profits during the year of assessment is primarily a question of fact. And thirdly, the amount of any profits or losses during the year of assessment must be ascertained by reference to ordinary principles of commercial accounting unless these are contrary to an express statutory provision in the Ordinance. These principles 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[2].

Profits

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1 All questions whether tax is payable or not are ultimately questions of statutory construction: see *Collector of Stamp Revenue v Arrowtown Assets Ltd* (2003) 6 HKCFAR 517 at §§35-36 per Ribeiro PJ and at §105 per Lord Millett NPJ.

2 See *Revenue and Customs Commissioners v William Grant & Sons Distillers Ltd* [2007] 1 WLR 1448 at p 1458 per Lord Hope of Craighead adopting the observation of Sir Thomas Bingham MR in *Gallagher v Jones* [1994] Ch 107.

15. While it is true, as the Commissioner submitted, that the amount of any profits is a question of fact, what constitutes "profits" within the meaning of the Ordinance and whether any disputed amount represents an assessable profit are questions of law.

16. The word "profits" is an ordinary English word and as such is capable of a broad variety of meanings. In these circumstances its meaning in any particular case depends on the context in which it is used. It has been consistently held in a series of cases dealing with the prohibition against the payment of dividends by companies except out of profits that the concept of profits in the context of company law is sufficiently broad to embrace unrealised profits[3]. The question in the present case is raised in a very different context; whether for the purpose of profits tax the word "profits" in s 14(1) of the Ordinance includes unrealised profits.

17. In seeking to persuade us to answer this question in his favour the Commissioner has relied heavily on the judgment of Fletcher Moulton LJ in Re Spanish Prospecting Co Ltd[4] where he said[5]:

> "The word 'profits' has in my opinion a well-defined legal meaning, and this meaning coincides with the fundamental conception of profits in general parlance …. 'Profits' implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates.
>
> For practical purposes these assets in calculating profits must be valued …. *Even if the assets were identical at the two periods it would by no means follow that there had been neither gain nor loss, because the market value – the value in exchange – of these assets might have altered greatly in the meanwhile.*" (emphasis added)

18. In my judgment the Commissioner's reliance on that case is misplaced, since the context in which the word "profits" was used was completely different. What was in issue was the meaning of the word "profits" in a contract of employment where the employee's salary was payable only out of the company's profits. The decision has rightly been described as "altogether independent of any taxing statute"[6]. In The Naval Colliery Co Ltd v CIR[7] Lord Warrington of Clyffe distinguished it as "not in point" because

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3 See *Commissioner of Taxation of the Commonwealth of Australia v Sun Alliance Investments Pty Ltd (In Liquidation)* (2005) 225 CLR 448 at p 506 and the cases there cited.

4 [1911] 1 Ch 92 CA.

5 At pp 98-99.

6 See *Dalgety v Commissioner of Taxes* (1912) 31 NZLR 260 at p 262 per Williams J.

7 (1928) 12 TC 1017 at p 1052 per Lord Warrington of Clyffe.

> "The learned Lord Justice was dealing not with a profit and loss account for the purpose of Income Tax but *with* a balance sheet intended to show the actual financial condition of a business at the end of a business year."

It has been repeatedly recognised in many different jurisdictions that when considering the meaning of the word "profits" in the Spanish Prospecting case Fletcher Moulton LJ was not dealing with its meaning in the context of taxation[8]; and that in that context the word has always been given a more restricted meaning.

19. In Read v The Commonwealth[9] the High Court of Australia was concerned with the meaning of the word "profits" in the context of social security payments. In the majority judgment Mason CJ, Deane and Gaudron JJ said[10]

> "In our opinion a mere increase in value of an asset does not amount to a capital profit. A profit connotes an actual gain and not a mere potential to achieve a gain. Until a gain is realised it is not 'earned, derived or received'. A capital gain is realised when an item of capital which has increased in value is ventured, either in whole or in part, in a transaction which returns that increase in value."

The reference to "derived" is not without interest, since under s 14(1) of the Ordinance profits are assessable to profits tax only if they are "arising in or derived from Hong Kong". While that particular requirement is specific to Hong Kong, the passage may be of wider application, since for more than a century the ordinary principles of commercial accounting have required the adoption of the accruals method of computing profits under which profits from the sale of trading stock are recognised not when the sale proceeds are received but when they are "earned" by the sale of stock.

20. The correctness of that decision in relation to Australian social security payments may be doubted, but not its correctness in relation to capital gains tax. As the High Court of Australia observed in *FCT v Sun Alliance Investments*[11] the case proceeded on the apparently erroneous assumption that the notion of capital profits in the social security legislation equated with the notion of capital gains for tax purposes. In the latter case, in a judgment delivered by the full court[12], the High Court of Australia rejected

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8 In *Re Income Tax Acts (No 2)* [1930] VLR 233 at 238 per Irvine CJ; at 245 per Macfarlan J; and at 250 per Lowe J; *Jebsen & Co v CIR* (1949) HKLR 312 *per* Gibson CJ at 315-316; *Quemont Mining Corp v Canada* [1967] 2 Ex CR 169 at §118 per Cattanach J; *Marra Developments Ltd v BW Rofe Pty Ltd* [1977] 2 NSWLR 616 at 628-629 per Mahoney JA; *FCT v Slater Holdings Ltd* (1984) 156 CLR 447 at 460 per Gibbs CJ.

9 1988 167 CLR 57.

10 At p 67.

11 [2005] CLR 288.

12 Gleeson CJ, Gummow, Kirby, Callinan and Heydon JJ.

Fletcher Moulton LJ's definition of the word "profits" as of universal application, even as a matter of ordinary usage. It said[13]

> "… the notion that a profit may be revealed or disclosed by a revaluation even where the composition of the assets held by a business does not change appears at odds with the focus, naturally attendant upon discussions of the 'ordinary usage' concept of income, on receipts coming into a taxpayer's hands."

The cardinal principles

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

22. It would be wearisome to cite all the numerous authorities in which these principles have been stated, but it is right to cite some of the more important if only in deference to the industry of counsel[14]. In *Duple Motor Bodies Ltd v Inland Revenue Commissioners*[15] Viscount Simonds said

> "… the Crown is not entitled to anticipate a profit which may or may not be made, as it might do if too high a value were put on stock-in-trade. …"

In the same case Lord Reid said

> "… 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."

Lord Reid, however, placed a gloss on the principle in relation to losses, for in the passage immediately following he said

> "But an exception seems to have been recognised 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

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[13] At p 504.

[14] Because of the difficulty in doing so no attempt has been made in the citation of authority which follows to allocate the *dicta* to a particular principle.

[15] [1961] 1 WLR 739, 748, 751.

> 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." (emphasis added)

23. Lord Reid's statement of the cardinal principle has been frequently cited with approval; see *B S C Footwear Ltd v Ridgway* per Lord Morris of Borth-y-Gest[16] and *Willingale v International Commercial Bank* per Lord Fraser[17], where Lord Keith[18] simply referred to

> "the rule that a profit may not be taxed until it is realised."

24. In *Willingale* in the Court of Appeal [19] Stamp LJ had referred to

> "the income tax rule that you may not be taxed on an anticipated profit."

When that case reached the House of Lords[20] Lord Salmon explained the meaning of "realised"[21]

> "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."

Under the prevailing accruals system of accounting, a profit is realised by sale of trading stock, not when the sale price is received, but when the amount of the sale price is credited to cash at bank or debtors.

25. In *B S C Footwear Ltd v Ridgway*[22] Lord Reid said[23]:

> "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. And conversely he may have made such an improvident contract in year one that he will certainly incur a loss in year two but he cannot use that loss to diminish his liability for tax in year one."

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16 [1972] AC 544 at p 560.
17 [1978] AC 834 at p 843.
18 At p 852.
19 [1977] Ch 78 at p 85.
20 *Supra* note 17.
21 At p 841.
22 *Supra* note 16.
23 At p 552.

26. In relation to profits the only doubt is whether the principle is truly non-statutory. In *Gallagher v Jones*[24] Sir Thomas Bingham MR said that the "general principle of income tax law that neither profit nor loss should be anticipated" which was not in doubt was "squarely based on the statutory provisions"[25]; while Nolan LJ suggested that it might equally be described as a restatement in a particular context of the statutory rule that tax should be charged on "full amount of the profits or gains *of the year*"[26]. But it does not matter, for whatever the source of the rule it is far too well established as a principle of law to be overturned except by clear and express statutory provision. It certainly cannot be overturned by the adoption of new standards of commercial accounting. But while it is true to say that neither profits nor losses may be anticipated, it is not true to say that the taxpayer may not use an unrealised loss to diminish his liability for tax.

Losses

27. In *Duple Motor Bodies Ltd v Inland Revenue Commissioners*[27] Lord Reid had suggested that in relation to losses there was a long established though illogical exception to the cardinal principle that neither profits nor losses may be anticipated[28], in that the taxpayer could bring into his accounts at market value an article of trading stock which had fallen in value below cost and "in this way anticipate a future loss". The words "in this way" show that the process which Lord Reid was describing is not strictly an exception to the principle that neither profits nor losses[29] may be anticipated; and for my part I do not consider that it is "quite illogical". Strictly speaking there is no exception to the rule that losses may not be anticipated. If at the end of an accounting period the value of an item of trading stock is the same as or greater than cost but it is sold in the following accounting period for less than cost, the loss is realised in the later period and cannot be brought forward to the earlier. This is the case even if the loss is realised before the accounts are signed off, for post-balance sheet events are relevant and can be taken into account only if they affect the position as at the balance sheet date.

28. If the market value of an item of trading stock which cost $100 is $120 at the end of year one and the item is sold in year two for $80, the application of ordinary principles of taxation means that for tax purposes in year one there is neither profit (because the profit has not been realised) nor loss (because the loss may not be anticipated); but there will be a loss of $20 in year two. Under the new accounting standards, however, the taxpayer's financial statements will show a profit of $20 in year one and a loss of $40 in year two.

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24 [1994] Ch 107 CA.

25 At p 135.

26 The corresponding words in the Ordinance are "the full amount of the profits … *during the year of assessment*".

27 *Supra* note 15.

28 Paragraph 22 *supra*.

29 Paragraph 25 *supra*.

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

30. The difference between making a provision for a diminution in value, which has always been permitted in a proper case, and substituting market value for cost in accordance with the new accounting standards, which is obligatory in every case, can be seen by considering a very simple example. Suppose the value of an item of trading stock which cost $100 fluctuates between $95 and $105 during the accounting period and is worth (i) $102 or (ii) $98 at the end of the period. The application of the principles of taxation results in neither taxable profit nor allowable loss in either case (because the profit in (i) is unrealised and the loss in (ii) does not justify a provision). Under the new accounting standards, however, the financial statements will be required to show a profit of $2 in (i) and a loss of $2 in (ii).

31. If contrary to expectation a provision later proves to be unjustified it should be wholly or partially written back, thereby producing a so-called “profit” of the amount written back. Thus if the value of an item of trading stock which cost $100 falls to $50 in year one and the reduction in value seems to be permanent, the auditors may agree that a provision of $50 should be made against the value of the stock, producing a loss of $50 in that year. If the item is sold in year two for $80 the provision should be written down by $30, thereby increasing the profits by $30 in year two. If it is sold for $120 the provision should be wholly written off, increasing the profits in year two by $70.

32. It may become clear even without a sale that the market has risen sufficiently to show that the provision was unjustified, in which case the amount of the over-provision should be written off, thereby increasing the profits or reducing the losses appearing in the profit and loss account. This appears to be inconsistent with the principle that profits must be “earned” or derived from a transaction by which they are realised; but the writing back of an unjustified provision is not a “profit” in the ordinary meaning of the term but is merely the reversal of a previous understatement of profits. If the taxpayer fails to write back a provision which later proves to have been unjustified, the Commissioner can challenge the accounts.

The role of the principles of commercial accounting

33. The Commissioner submitted that the amount of any profits or losses during the year of assessment must be ascertained by reference to the ordinary principles of commercial accounting unless these are contrary to an express statutory provision in the Ordinance, and relied on the decision of this Court in Commissioner of Inland Revenue v Secan Ltd[30] for this purpose. That is a misreading of my judgment in that case. After citing the celebrated passage in the judgment of Sir John Pennycuick VC in Odeon Associated Theatres Limited v Jones[31], in which he explained the relationship between accountancy evidence and the ascertainment of the taxpayer's assessable profits, I said[32]:

> "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."

It should be noted that I said "in conformity with the Ordinance", not "in conformity with an express provision of the Ordinance".

34. It is a fundamental principle of the constitution of Hong Kong, as of England, Australia, the United States and other democratic societies, that the subject is to be taxed by the legislature and not by the courts, and that it is the responsibility of the courts to determine the meaning of legislation. This is not a responsibility which can be delegated to accountants, however eminent. This does not mean that the generally accepted principles of commercial accounting are irrelevant, but their assistance is limited.

35. In the present case the subject matter of the tax is "profit", and the question what constitutes a taxable profit is a question of law. While the amount of that profit must be computed and ascertained in accordance with the ordinary principles of commercial accounting, these are always subject to the overriding requirement of conformity, not merely with the express words of the statute, but with the way in which they have been judicially interpreted. Even where the question is a question of computation, the court must "always have the last word"[33].

36. In some of the earlier cases on which the Commissioner relied the courts have used language which might be taken to suggest that the ordinary principles of commercial accounting must prevail unless inconsistent with an express statutory provision in the taxing statute. But the passages in question need to be read in context. In Whimster v The

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30 (2000) 3 HKCFAR 411.

31 48 TC 257 at p 273.

32 At p 419.

33 *Duple Motor Bodies Ltd v Inland Revenue Commissioners* (note 15 *supra*) at p 753 per Lord Reid.

Commissioners of Inland Revenue[34], for example, Lord Clyde said that the taxpayer's profits must be ascertained in accordance with the ordinary principles of commercial accountancy "and in conformity with the rules of the Income Tax Act". He observed that the rule that stock should be brought into the account at the lower of cost and net realisable value was derived from the ordinary principles of commercial accounting "although there is nothing about this in the taxing statutes". In that case, however, the Court of Session rejected an attempt by the taxpayer to deduct future anticipated losses in ascertaining its profits for the accounting period because the taxpayer had failed to show that its accounts were drawn in accordance with ordinary commercial practice. The case, therefore, has no relevance when considering the circumstances which require accounts drawn in accordance with ordinary principles of commercial accounting to be modified for tax purposes.

37. In *Sun Insurance Office v Clark*[35] Viscount Haldane said that

> "Questions of law can only arise when (as was not the case here) some express statutory direction applies and excludes ordinary commercial practice, or where, by reason of its being impracticable to ascertain the facts sufficiently, some presumption has to be invoked to fill the gap."

But that was a case in which the amount of the profits had to be estimated and where Lord Loreburn LC observed[36]

> "There is no rule of law as to the proper way of making an estimate …. A rule of thumb may be very desirable, but cannot be substituted for the only rule of law that I know of, namely, that the true gains are to be ascertained as nearly as it can be done."

38. In *Southern Railway of Peru Ltd v Owen*[37] Lord Radcliffe said that he

> "should view with dismay the assertion of legal theories as to the ascertainment of true annual profits which were in conflict with current accountancy practice and were not required by some special statutory provision of the Income Tax Acts."

In rejecting the Crown's argument that a provision for contingent future liabilities was contrary to a supposed rule of law, however, Lord Radcliffe did not confine his remarks to the statute. He said

> "In my opinion, there is no such rule of law governing the ascertainment of annual profits. Where does it come from? Not from anything to be found in

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34 (1926) SC 20, 25.

35 [1912] AC 443, 455.

36 At p 454

37 [1957] AC 334, 360.

> the Income Tax Act. … Not from any decided authority which is binding on your Lordships …."

In that case, moreover, the House of Lords overturned the finding of the Special Commissioners in favour of the taxpayer after hearing the evidence of its auditor and another independent accountant of distinction, and despite the auditor having testified that he would not have signed the balance sheet without qualification unless the disputed provision for contingent future liabilities had been made. The provision was disallowed not because it was inconsistent with an express statutory provision but because, in the words of Lord Radcliffe, the provision was "well on the wrong side of what was permissible".

39. It is clear beyond argument that accounts drawn up in accordance with the ordinary principles of commercial accounting must nevertheless be adjusted for tax purposes if they do not conform to the underlying principles of taxation enunciated by the courts even if these are not expressly stated in the statute[38]. In *Willingale v International Commercial Bank*[39] Lord Fraser said 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." (my emphasis)

There are many other statements in the authorities to the same effect.

40. In particular, the principles of commercial accounting must give way to the core principles that profits are not taxable until they are realised and that profits must not be anticipated. In the passage cited above from his speech in *B S C Footwear Ltd v Ridgway*[40] Lord Reid stated in terms that

> "The application of the principles of commercial accountancy is, however, subject to one well-established though non-statutory principle. Neither profit nor loss may be anticipated."

In *Willingale v International Commercial Bank*[41] it was common ground that the taxpayer's accounts were drawn up in accordance with the principles of commercial accountancy[42]. Yet they were held to be "not a proper basis for assessing [its] liability for corporation tax" because they contravened the rule that profits may not be anticipated (per Lord Fraser[43]) or that a profit may not be taxed until realised (per Lord Keith[44)].

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38 See *B S C Footwear Ltd v Ridgway* (note 16 *supra)* at p 562 per Lord Guest.

39 Note 17 *supra*.

40 Note 23 *supra*.

41 *Supra* note 17.

42 See [1977] Ch At pp 97-8 per Sir John Pennycuick.

43 At p 847.

44 At p 852.

41. Most of the cases in which the courts have considered the circumstances in which recourse may be had to the evidence of accountants were concerned with the allocation of profits, or more usually expenditure, to the correct period of account. In *B S C Footwear Ltd v Ridgway*[45] Lord Reid said[46]

> "In my view, there is a difference between a question whether a sum is or is not taxable at all, and a question as to the proper year to which an admitted profit should be allocated. To the former there can only be one answer. The latter may not be capable of a definite answer: one may say that one answer is preferable but that another is possible. Much will depend on proper accounting practice and that may alter in the course of time."

42. There is also a difference between determining the amount of any profits, which is a matter of computation, and determining whether a given sum is or is not a taxable profit for the purpose of the Ordinance, which is a question of law. Most of the statements that primacy should be accorded to the ordinary principle of commercial accounting have been made with reference to the first question and not the second. Thus in *Revenue and Customs Commissioners v William Grant & Sons Distillers Ltd*[47] Lord Hope of Craighead said that

> "The golden rule is that the profits of a trading company must be computed in accordance with currently accepted accounting principles." (my emphasis)

43. The question in that case was whether depreciation of unsold stock (which is a cost) could be carried forward and treated as part of the cost of future sales. In his speech Lord Hoffmann indicated that in *Secan*[48] I gave two contradictory answers to the question, for my statement that the Ordinance did not prohibit the capitalisation of interest suggested one answer and my analysis of the accounting treatment another. With respect to Lord Hoffmann I plainly used the expression "capitalisation of interest" in its normal meaning to describe the accounting treatment which I later explained in detail. As I explained, normally interest is an overhead like rent and deducted as an expense of the business as a whole in the year in which it is paid. When it is capitalised, however, it is treated as a cost of acquisition of an asset. This is similarly deducted in the year in which it is paid but is matched by a corresponding increase in the value of the asset, producing neither profit nor loss in that year but reducing the profit in the year in which the asset is sold

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45 *Supra* note 16.

46 At p 555.

47 [2007] 1 WLR 1448, 1458. The decision has been strongly criticized as leading to the conclusion that the cost of unsold stock, unlike the cost of stock which is sold during the year, is not deductible in the year in which it is incurred, and it may be necessary in future for this court to decide whether it should be applied in this jurisdiction.

48 Note 30 *supra.*

by the amount of the increase in its cost. There are not two different systems of computation but a single system which has had the misfortune to be explained in different ways.

Financial Statements

44. It must be borne in mind that the new accountancy standards are directed to the preparation of financial statements and not tax computations, and that the two serve different purposes. Financial statements are prepared in order to give investors, potential investors, financial advisers, and the financial markets generally a true and fair view of the state of affairs of the company and in particular its financial position and profitability. Those who read them are concerned not with the past but with the future, and in particular the future profitability of the company. The Ordinance, however, is directed to the past. The Commissioner is not concerned with the likelihood that the taxpayer will make profits in future but whether it made them in the past.

45. The courts have had frequent occasion to comment that while a taxpayer's financial accounts, drawn in accordance with ordinary principles of commercial accountancy, may be appropriate for the purpose of showing its financial position they may not be appropriate for the assessment of tax[49.] Where they are not appropriate for this purpose, the taxpayer is entitled or may be required to adjust them for tax purposes: the cases show both situations. In *Minister of National Revenue v Anaconda American Brass Ltd*[50] Viscount Simonds, giving the opinion of the Privy Council, said

> "Their Lordships do not question that the Lifo method or some variant of it may be appropriate for the corporate purpose of a trading company. Business men and their accountant advisers must have in mind not only the fiscal year with which alone the Minister is concerned. It may well be prudent for them to carry in their books stock valued at a figure which represents neither market value nor its actual cost but the lower cost at which similar stock was bought long ago. A hidden reserve is thus created which may be of use in future years. But the Income Tax Act is not in the year 1947 concerned with the years 1948 or 1949: by that time the company may have gone out of existence and its assets been distributed … the evidence of expert witnesses, that the Lifo method is a generally acceptable, and in this case the most appropriate method of accountancy, is not conclusive of the question that the court has to decide. That may be found as a fact by the Exchequer Court and affirmed by the Supreme Court. The question remains whether it conforms to the prescription of the Income Tax Act. As already indicated, in their Lordships' opinion it does not."

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[49] See the observations of Lord Warrington of Clyffe in *The Naval Colliery* case cited in para 14 *supra*.

[50] [1956] AC 85, 102.

46. In *Willingale v International Commercial Bank*, where the taxpayer's financial statements were found to be drawn up in a way which anticipated future profits, Lord Fraser said that there were no doubt excellent commercial reasons for preparing the accounts in that way and borrowed the words of Walton J[51] that 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."

Despite this he held that they were not a proper basis for assessing the bank's liability to tax.

47. In the present case the taxpayer's financial statements, prepared in accordance with the new accounting standards, showed a single figure for the profits whether realised or unrealised during the accounting period, followed by a breakdown between realised and unrealised profits. Before 1999 the profit and loss account would not have shown unrealised profits and the balance sheet would have shown stock in trade at the balance sheet date at cost, excluding any increase in its value during the preceding accounting period. But it is difficult to believe that the taxpayer would not have wanted in its own interest, or possibly have been obliged by its auditors, to advertise its success by providing in a note to the accounts the value of the stock still held at the end of the year. If so, then the change is merely a matter of presentation in which the contents of a note to the accounts have been elevated to the balance sheet.

The new accounting standards

48. The new accounting standards have been adopted internationally by many different countries including the United Kingdom. Their purpose, eminently laudable, is to harmonise so far as possible the preparation of financial statements so that they may be understood by those who read them and who live in a global world. They are not intended, and cannot sensibly be thought to have been intended, to harmonise the tax liabilities of taxpayers carrying on businesses in countries with greatly different tax regimes. The international nature of the new accounting standards militates against their use for tax purposes.

49. As the Respondent observed in its printed case, the existence of mandatory international accounting standards for the preparation of financial statements provides surer evidence than was available in the past of the ordinary principles of commercial accounting, but they cannot take the place of the Ordinance as interpreted by the courts.

50. It is of some interest to note that the original view of the Inland Revenue in the United Kingdom was that financial statements prepared in accordance with the new accounting standards were not appropriate for the assessment of tax. It is understood that the Inland Revenue have changed their mind, possibly influenced by a government

[51] [1976] 1 WLR 657,663.

desperate to raise as much revenue as possible to fill a hole in the public finances. It remains to be seen whether their changed approach will be challenged. If it is, then these proceedings will no doubt be considered a dry run.

Conclusion

51. In my judgment the taxpayer's financial statements, prepared in accordance with mandatory international accounting standards, record both profits which the taxpayer has realised during the accounting period and which are assessable to tax and increases in the value of its trading stock during the period which represent unrealised profits and are not assessable to tax. In preparing its tax computations the taxpayer was entitled to remove the amounts of its unrealised profits as not chargeable to tax.

52. I would dismiss the appeal.

Chief Justice Ma :

53. For the above reasons, the appeal is unanimously dismissed. As to costs, we made an order nisi that the respondent should have the costs of the appeal, such costs to be taxed if not agreed. If any party wishes to have a different order for costs, written submissions should be served on the other parties and lodged with the Court within fourteen days of the handing down of this judgment, with liberty on the other parties to lodge written submissions within fourteen days thereafter. In the absence of such written submissions, the order nisi will stand absolute at the expiry of the time limited for these submissions.

(Geoffrey Ma)	(R A V Ribeiro)	(Robert Tang)
Chief Justice	Permanent Judge	Permanent Judge

(Henry Litton)	(Lord Millett)
Non-Permanent Judge	Non-Permanent Judge

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

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