In Time for Thanksgiving: The Court of Final Appeal Awards Nice Cheer to the Taxpayer

On 12 November 2013, the Court of Final Appeal handed down a victory for the taxpayer in *Nice Cheer Investment Limited v. Commissioner of Inland Revenue* FACV 23/2012. The Court clarified once and for all the relation between commercial methods of accounting and the statutory provisions of tax law. The Court also re-affirmed the general principle that while profits can only be taxed when they are actually earned and realised, the taxpayer may still make provision for unrealised losses when calculating its profits tax liability.

Facts

For a more detailed summary of the background of the case, please refer to "*Court of Appeal's Recent Tax Decisions*", a Mayer Brown JSM legal update published on 27 June 2012.

The taxpayer in this case, Nice Cheer, is a Hong Kong private company engaged in investment trading with quoted securities as its stock-in-trade. The tax assessments in contention in this case ranged from the years 1999/2000 to 2005/2006, starting from the point when Nice Cheer adopted new accounting standards in 1998. The then-new accounting standards mandated that changes in the value of unrealised trading stock held at the end of the accounting period had to be recorded in the statements.

When computing its assessable profits and allowable losses for the years in question, Nice Cheer had excluded its unrealised profits (i.e., its paper gains), but claimed tax deductions for its unrealised losses (i.e., its paper losses), as provision for the stock's diminution in value. The Inland Revenue Department (IRD) disagreed with this methodology. While accepting the deduction for paper losses, the IRD credited back the paper gains, resulting in an increase of HK$250 million in profits tax over Nice Cheer's original calculation.

Nice Cheer appealed to the Commissioner, who confirmed the assessment. However, both the Court of First Instance, and a unanimous Court of Appeal, subsequently found in favour of Nice Cheer. The Commissioner appealed to the Court of Final Appeal.

In the CFA

The Commissioner essentially had two major arguments: first, that "profits" included unrealised profits; and second, that the amount of profits in a year must be ascertained by ordinary methods of commercial accounting unless they conflict with an express statutory provision.

UNREALISED GAINS AND LOSSES

The Commissioner, relying on an older English case[1], had attempted to argue that the word "profits", which is not defined in the Inland Revenue Ordinance, included unrealised profits. Lord Millett NPJ, delivering the judgment of the CFA, declined to follow the case cited by the Commissioner on grounds that it was not dealing with the meaning in the context of taxation. Citing a host of authorities, Lord Millett observed that there are two cardinal principles of tax law:

1. The word "profits" connotes actual or realised, and not potential or anticipated, profits; and
2. Neither profits nor losses can be brought forward.

The learned judge proceeded to explain the "exception" where a taxpayer could take advantage of unrealised losses on one hand, but not be assessed tax on his unrealised gains on the other. Lord Millett pointed out that the unrealised losses can merely serve as a provision, and not a permanent deductible. The auditor must confirm the unrealised loss is material and likely to occur, and if it does not, the provision must be reinstated or be subject to challenge by the Commissioner.

[1] *Re Spanish Prospecting Co Ltd* [1911] 1 Ch 92, English Court of Appeal.

COMMERCIAL ACCOUNTING STANDARDS

As for the Commissioner's argument that the actual amount of profits and losses should be ascertained by reference to accounting standards, Lord Millett dismissed it as a misreading of one of his earlier judgments[2]. He explained that the purpose of new accounting standards was to give interested persons a true and fair view of the company, including its financial health and profitability in the future. The Commissioner, on the other hand, was not concerned with the future, but with assessing what a company had already accomplished in the past.

More fundamentally, taxation is levied by the legislature and the statutes are to be interpreted by the courts. It would be absurd if accountants could somehow determine the assessable profits for a taxpayer. Lord Millett further said it was "clear beyond argument" that accounts drawn up in accordance with principles of accounting must nevertheless be adjusted for tax purposes if they did not conform to the principles of tax law, in particular, the cardinal principles outlined above.

Ramifications

The Inland Revenue Department's Departmental Interpretation and Practice Note No. 42 ("DIPN 42"), published in November 2005, states that where a taxpayer adopts an accounting standard in its audited accounts, the Commissioner will follow that standard and assess the corresponding tax liability. Tax practitioners have generally adopted DIPN 42. As the CFA has now confirmed the lower courts' judgments that the principles of tax law will always prevail over any inconsistencies generated by accounting standards, this particular aspect of DIPN 42 should not be followed. Moreover, when preparing accounts, the taxpayer should actively adjust those accounts in order to conform to the principles of taxation.

The CFA also noted the Inland Revenue in the United Kingdom had originally doubted the new accounting standards as being suitable for the assessment of tax. Owing to a possible need for government revenue, the Inland Revenue had changed its mind. Lord Millett considered that the present decision of the CFA could well be considered a dry run for any challenges to that changed position.

Lastly, section 70A of the Inland Revenue Ordinance allows taxpayers to apply for correction of an assessment within six years after the end of a year of assessment or within six months after the date on which the relevant notice of assessment was served, whichever is the later. It remains to be seen whether taxpayers who paid profits tax on unrealised profits that were never actually realised, may be eligible for a refund due to the decision of the CFA.

[2] In *Commissioner of Inland Revenue v. Secan Ltd* (2000) 3 HKCFAR 411.

Contact Us

For more information about this Legal Update or for an informed opinion on your taxation options following this landmark decision of the Court of Final Appeal, please contact the following person or your usual contacts with our firm.

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