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來函檔號 Your Ref. : LS/B/3/18-19

By email (bloo@legco.gov.hk)

13 December 2018

Mr Bonny LOO
Assistant Legal Adviser
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Dear Mr Loo,

Inland Revenue (Amendment) (No. 7) Bill 2018 ("Bill")

Thank you for your letter of 30 November 2018. Our response to your letter is set out below –

Interim measures to accept tax returns prepared on fair value basis

(a) Since 1 January 2005, enterprises in Hong Kong have been required to account for financial instruments on a fair value basis in accordance with applicable accounting standards. As such, taxpayers' accounting profits may or may not include unrealized profits. In *Nice Cheer Investment Ltd v Commissioner of Inland Revenue* (2013) 16 HKCFAR 813 ("Nice Cheer case"), Nice Cheer contended that the increase in the value of trading securities (held at the end of the year) should not be subject to profits tax and Nice Cheer had therefore excluded such increase (i.e. unrealized profits) in its tax returns. The Inland Revenue Department ("IRD") took the

view that such unrealized profits were taxable since they had been recognized as profits in accordance with generally accepted accounting principles and assessed the amounts to tax accordingly. The Court of Final Appeal ("CFA") decided that such unrealized profits should not be chargeable to tax under the existing provisions of the Inland Revenue Ordinance ("IRO"). After the CFA's judgment in the Nice Cheer case, financial institutions and securities dealers have requested the IRD to continue accepting profits computed on a fair value basis for tax computation purpose. Otherwise, they would have to incur substantial costs to re-compute their profits on a realization basis before they could ascertain and exclude any amounts of unrealized profits from tax returns. In view of the industry's request and the practical difficulties, the IRD has been accepting tax returns from enterprises with assessable profits computed on a fair value basis as an interim administrative measure.

We consider that the interim administrative measure is compatible with the CFA's judgment in the Nice Cheer case. Our reasons are as follows –

(i) The interim administrative measure is not a measure seeking to demand or charge profits tax on unrealized profits. It is a measure in response to the industry's request to the IRD to accept tax returns on assessable profits computed on fair value basis. As these tax returns did not show any particular amount of unrealized profits, such amount (if there was any) was unknown to the IRD.

(ii) In practice, the IRD is not provided with information to decide whether the profits reported by taxpayers had included any unrealized profits. Depending on the classification of a financial instrument, changes in its fair value (e.g. the increase in the value of trading securities held at the end of the year in the Nice Cheer case) may or may not be recognized in the taxpayer's profit and loss account. Even if there was likelihood that unrealized profits were included in reported profits, the IRD could not ascertain the amount involved based on the profits tax returns. The amount of any

unrealized profits so included has to be provided by taxpayers if they wish to exclude such profits for tax purpose.

(iii) Filing tax returns with computations of chargeable profits is primarily the duty of taxpayers. Based on the profits reported by the taxpayers, the IRD then make appropriate assessments accordingly by virtue of section 59(2)(a) and follow-up by audits as appropriate. The IRD is not in a position to advise taxpayers how they should compute their profits for tax purposes or to analyse their financial statements to help them identify any potentially non-taxable items.

For example, a taxpayer's offshore profits are not taxable under the existing provisions of the IRO and the taxpayer is entitled to substantiate that part of the taxpayer's profits are offshore profits and exclude them from the tax return. However, if a taxpayer reported its whole profits (i.e. both onshore and offshore profits) for tax assessment, profits tax would be assessed in accordance with the profits reported by the taxpayer. The fact that in such circumstances the assessment covers, without the assessor's knowledge, non-taxable profits should not denote any ultra vires act. If the taxpayer later argues that the profit tax should be re-assessed to exclude the non-taxable offshore profits, the taxpayer can invoke section 64 or section 70A of the IRO to lodge an objection or make a claim to correct the assessment.

(iv) Similarly, it is up to a taxpayer who submits computation of profits on a fair value basis to exclude unrealized profits which as decided by the CFA are not taxable. Where a taxpayer (who knows or should have known that unrealized profits can be excluded as a matter of law) chooses to report an amount of assessable profits computed on a fair value basis and does not exclude unrealized profits, the mere fact that the IRD assesses profits based on the amount of profits computed by the taxpayer should not denote any ultra vires act.

Nonetheless, if the taxpayer for some reasons subsequently argues that a certain amount of the computed profits which are unrealized profits should be non-taxable, the taxpayer is entitled to invoke the objection or correction mechanism under the IRO and the IRD may make suitable adjustment on the assessed profits in compliance with the principles laid down in the CFA's decision in the Nice Cheer case. Hence, the interim administrative measure does not go against the CFA's decision by accepting computation of profits based on a fair value basis.

(b) The IRD does not dispute that tax paid pursuant to an ultra vires demand by a public authority or pursuant to mistake should be recoverable. As mentioned in (a), the interim administrative measure does not seek to demand or charge profits tax on unrealized profits. Nonetheless, if a taxpayer later argues that a particular amount of unrealized profits had been mistakenly included in his reported assessable profits, the taxpayer is entitled to seek recovery of the relevant part of the tax paid by lodging an objection or applying for correction under the IRO. Practically, even if the unrealized gains were not taxed during the interim arrangement period, any cumulative revaluation gains during such period will be brought into account for the election year as provided in the proposed section 18H(3).

(c) Based on the considerations provided in paragraphs (a) and (b) above, we consider that saving provisions are not necessary.

Yours sincerely,

(Ms Pecvin Yong)
for Secretary for Financial Services and the Treasury

c.c.

Commissioner of Inland Revenue	(Attn: Mr KK CHIU)
Department of Justice	(Attn: Miss Betty CHEUNG Ms Carmen CHAN)