Inland Revenue Appeal No. 1 of 1997

IN THE HIGH COURT OF HONG KONG

COURT OF FIRST INSTANCE

BETWEEN

COMMISSIONER OF INLAND REVENUE Appellant

and

GENERAL GARMENT MANUFACTORY (Hong Kong) LTD Respondent

Before: The Hon. Mr. Justice Barnett in Court
Hearing: 4th July 1997

HANDING DOWN OF JUDGMENT: 14TH JULY 1997

J U D G M E N T

At the beginning of 1989, the Respondent-taxpayer found itself in the happy position of being awash with US dollars. Between 4th January and 31st March, it used these dollars to purchase Japanese Yen worth HK$99.8m. Unfortunately, the taxpayer took an exchange loss on these purchases. It claimed, and initially was allowed, these losses as deductions against profits tax. Later, however, an assessor of the Inland Revenue Department issued additional assessments which disallowed the exchange losses as deductions and claimed additional profits tax. The taxpayer objected to these additional assessments but the assessments were determined by the Commissioner of Inland Revenue. Upon an appeal by the taxpayer, the Board of Review (Inland Revenue) allowed the appeal and ordered that these assessments should

be annulled. Against that decision of the Board, the Commissioner now appeals by way of case stated.

Since incorporation in 1957, the taxpayer had been carrying on a business of garment manufacturing and trading. The garment manufacturing was carried on both in Hong Kong and Taiwan. In 1988, the garment business in Taiwan ceased. As a result, US dollars became surplus to the requirements of the taxpayer. For understandable tax reasons, the US dollars were moved from Hong Kong to Singapore and by January 1989, it appears that approximately US$12m were on deposit in Singapore.

On 31st December 1988, the company declared a dividend of HK$234.00 per ordinary share. On 4th January 1989, the taxpayer purchased Yen worth HK$3.9m with US dollars which were still on deposit in Hong Kong. The following day, the US dollar deposits in Singapore were converted from a one month term to call.

On 10th and 11th January, there were three purchases of Yen totalling HK$54.6m. Between 13th and 23rd January, there were four additional purchases of Yen totalling HK$17.9m. There were four further purchases of Yen between 16th and 23rd March worth HK$15.6m.

On 30th March, the taxpayer declared a further dividend of HK$350.00 per share totalling HK$105m. At this point, dividends declared were worth HK$175.2m while Yen purchases were worth HK$92m. The next day on 31st March, there was a final purchase of Yen worth HK$7.788m.

On 25th May, Yen worth HK$23.4m were sold. On 4th August, the balance of the Yen holdings was used in specie in partial satisfaction of the dividends.

Because the value of the Yen had gone down, the taxpayer made an exchange loss of HK$3,560,802.00 for financial year 88/89 and HK$4,050,768.00 for the year 89/90. These losses were, as I said, initially allowed by the assessor. The assessor then revised his view of these losses and decided that they were capital in nature. On 25th June 1991, he raised two additional profits tax assessments. HK$544,174.00 additional tax was payable for the year 88/89 and HK$557,011.00 for the year 89/90.

On 25th July 1991, the taxpayer objected to the additional assessments. It was submitted that the US dollars were converted into Yen with the intention of deriving a speculative gain on the exchange rate movements of the Yen. Any gains or losses from such speculative activities, therefore, would be revenue in nature. The taxpayer went on to argue that the source of the losses was in fact Hong Kong. The assessor apparently accepted the argument in relation to the source of the losses but, on

4th April 1995, the Commissioner confirmed the two additional assessments. The taxpayer lodged Notice of Appeal on 3rd May 1995.

Before the Board, two issues arose. First, whether the taxpayer's activities in relation to the Yen purchases were trading or an adventure in the nature of trade. Second and surprisingly, whether the profits or losses arising from those activities, if of a revenue nature, had their source in Hong Kong. The Board found in favour of the taxpayer on both issues. I have to say that I find the Board's decision in relation to the source of the taxpayer's losses to be a little surprising. Because the Commissioner did not challenge this finding, it was not argued before me on appeal. It does appear, however, that apart from the decision to buy Yen and the placing of the necessary orders by telephone in Hong Kong, the holding of the currencies and their conversions all took place in Singapore. Equally surprisingly, the Commissioner decided to challenge the Board's factual finding that the taxpayer's activities constituted trading. He asked the Board to state a case which contains the following questions of law for my opinion:

> "(a) On the evidence before it the Board could not reasonably have found as it did as follows:
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> (i) at paragraph (5)(f) above
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> On 5 January 1989 the Taxpayer converted one term deposit in the Singapore account of approximately US$12,000,000 into a call deposit. The conversion was intended to provide the working capital required for the Taxpayer's dealing in Japanese Yen.
>
> (ii) at paragraph (6)(g) above
>
> When the one month term deposits of US Dollars in Singapore matured on 5 January 1989 the Taxpayer converted the deposits into a call deposit to provide the working capital for Japanese Yen dealings.
>
> (b) Whether, on the facts properly found by the Board, the true and only reasonable conclusion is that the Taxpayer did not carry on a trade or an adventure in the nature of trade in foreign currency and the exchange losses in question were capital in nature and not deductible in accordance with the provisions of Sections 16 and 17 of the Inland Revenue Ordinance."

For the Commissioner, Mr. Raymond Faulkner S. C. argued that the appeal should be allowed either because the true and only reasonable conclusion contradicts the Board's determination: see Edwards v. Bairstow & Harrison (1956) A. C. 14, or because the Board's findings cannot stand in view of various misdirections in fact and law: Marson v. Morton (1986) S. T. C. 463. As a fallback position, Mr. Faulkner also argued that because of the misdirections the case should be remitted to the Board with the court's of opinion for the Board to revise the assessment in accordance with Section 69 (5) of the Inland Revenue Ordinance (Cap. 112).

In seeking to persuade me that the only true conclusion the Board should have reached was the opposite of the one it did reach, Mr. Faulkner faced a very difficult task. Before the Board, two witnesses gave evidence on behalf of the taxpayer. The principal witness was Margaret Cheung, a director of the taxpayer, who had responsibility for day-to-day management of the taxpayer at the relevant time. In her witness statement, Ms. Cheung said that she was keen to put the surplus US dollars to good use. From her reading of the Asian Wall Street Journal and from consultation with others including her eldest brother, she came to the view that the Yen would appreciate significantly in value in the short term relative to the US dollar. She therefore decided to buy Yen on the simple basis "buy low and sell high". Initially, a small paper profit was made. Ms. Cheung did not think it worth selling at that stage and directed the taxpayer's financial controller to make further purchases. Unfortunately, the exchange rate deteriorated so that it became necessary to reduce the average cost of the taxpayer's Yen holding by buying further amounts of Yen to enable the company "to recoup its losses and make profits more easily". Eventually, the position got out of control and Ms. Cheung decided to end the purchase of Yen at the end of March 1989. Ms. Cheung was cross-examined before the Board by the Commissioner's representative. Then in re-examination, she was asked why she wanted to buy Yen and said "for quick profit from the exchange rate" and "so I though well a quick profit, January/February, that's what I did".

On that evidence, plainly, there was no question of investment and the evidence virtually closed the door on any idea of these transactions being capital in nature. Nevertheless, Mr. Faulkner submitted that the Board misdirected itself in a number of ways

1) By determining that the answer lay only in the evidence of the two witnesses thus discounting the value of other relevant evidence.

2) By placing substantial reliance on the evidence of Ms. Cheung despite her own repeated assertions of the limitations of her financial knowledge.

3) By regarding the evidence of the other witness, the financial controller, as corroborative of a trading intention when it clearly fell far short of such.

4) By impeding the logical adducing of evidence by the interruption of cross-examination for the purpose of discussions on matters of law and extraneous opinion.

5) By basing its determination upon "facts" several of which were inaccurate, namely

(a) By stating that a dividend was declared after the failure of the speculation, that is after March 1989 when the agreed facts show that dividends were declared on 31st December 1988 and 30th March 1989.

(b) By stating that "averaging down" is a characteristic of trading when both traders and investors employed this technique.

(c) Accepting the use of the term "working capital" to describe the funds invested in the speculation as conclusive of the contention that it was in fact 'working capital".

(d) By regarding a statement of a "strategy" of trying "to buy Yen at a low price and sell it at a high price" as indicative of trading when this is no more than a description of the intention of any investor.

Mr. Faulkner said that the Board also made various mistakes of law

1) By refusing to countenance any argument as to the "badges of trade'.

2) By equating "business transaction" with "trading transaction".

3) By failing to adopt a proper legal analysis in arriving at its decision.

The mischief arises because, as is apparent from the transcript, the Board through its Chairman had effectively reached the conclusion that the purchase of Yen was a trading activity by the conclusion of Ms. Cheung's evidence. Thereafter, the focus of the hearing was more upon the issue of source. Of course, it was wrong for the Board or any of its members to have reached a conclusion before the end of the hearing. In so doing, they would be deflected from a proper consideration of all the evidence which included documentary evidence, such as accounts, as well as the oral evidence of the witnesses. They would also be less inclined to pay proper attention to any submissions made to them.

Unless there was reason to doubt the evidence of Ms. Cheung, however, and in my view there was not, it is difficult to see what other conclusion the Board could have reached. The Board found the evidence of Ms. Cheung and the financial controller, Mr. Tsang, to have been satisfactory. Mr. Faulkner launched an attack upon their evidence and the failure of the Board properly to analyse it. Whilst it is true that Ms. Cheung showed herself to be less than financially adept and while it is true that there was some contradiction between the evidence of the two witnesses, I am bound to say that Mr. Faulkner's attack lacked any real substance. Certainly there is no basis on which I could consider taking a contrary view of these witnesses.

I accept that the Board's analysis contained in the stated case contains little true analysis of the taxpayer's activities. It amounts to little more than a recital of those activities and the reasons therefor. It certainly tended to assume that there was trading. It accepted without any consideration the evidence that the US dollar deposits were to provide "working capital" for the purchase of Yen. The Board also described what the taxpayer did as "a business transaction" and seems to have equated that with trading.

What it amounts to is this. On evidence which the Board could accept, and which in my view it properly accepted, the conclusion which the Board reached was certainly open to it and, in my view, the only one which was open to it in the circumstances.

There are, of course, cases where there are complicated facts which require detailed analysis in order to arrive at a proper conclusion. In my judgment, this was not one of those cases. It was, as the Chairman seems rapidly and rightly to have found, very simple and one where the proper conclusion emerged without difficulty.

The only serious error which the Board made was to forget that dividends had been declared both before the purchase of Yen began and again before the final purchase. As I understood it, Mr. Faulkner's argument was that the Board must necessarily have inferred that the surplus US dollars were ear-marked for distribution as those dividends. If so, those dollars would have been capital in nature. That capital nature would not necessarily have been changed by the taxpayer's efforts to try and turn a quick profit on the dollars. With a correct appreciation of the position, the Board might have reached a different conclusion from the one which it did.

It is useful in this context to refer to the speech of Lord Wilberforce in Simmons v. I. R. C. (1980) 1 W.L.R. 1196 at p. 1198

> "What I think has to be considered here is, rather, precisely what the commissioners have found as to the companies' intentions, and whether their findings are consistent or intelligible. I do this with, I hope, a proper

> appreciation of the commissioners' presentation: and a disposition to uphold any decision of theirs on factual matters if I can properly do so.
>
> One must ask, first, what the commissioners were required or entitled to find. Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment? Often it is necessary to ask further questions: a permanent investment may be sold in order to acquire another investment thought to be more satisfactory; that does not involve an operation of trade, whether the first investment is sold at a profit or at a loss. Intentions may be changed. What was first an investment may be put into the trading stock - and, I suppose, vice versa. If findings of this kind are to be made precision is required, since a shift of an asset from one category to another will involve changes in the company's accounts, and, possibly, a liability to tax: see Sharkey v. Wernher (1956) A. C. 58. What I think is not possible is for an asset to be both trading stock and permanent investment at the same time, nor to possess an indeterminate status - neither trading stock nor permanent asset. It must be one or other, even though, and this seems to me legitimate and intelligible, the company, in whatever character it acquires the asset, may reserve an intention to change its character. To do so would, in fact, amount to little more than making explicit what is necessarily implicit in all commercial operations, namely that situations are open to review."

Two useful matters emerge from that passage. First, the intention in relation to an asset is capable of change. Second, what is important is the intention at the time of acquisition. If that question is posed in the context of the present case, it is clear that the taxpayer's intention at the time of acquisition of the Yen was to dispose of it quickly for a profit, not to acquire a permanent investment.

Error though there was on the part of the Board, I do not consider that in all the circumstances it warrants the over-turning of the Board's decision or calls for the case to be remitted to the Board for further consideration.

I consider that the Board's decision as to trading to be not open to attack. As far as the questions of law posed for my opinion are concerned, I find that on the

evidence the Board could reasonably have found the two facts which it did. Further, that the taxpayer did not carry on a trade was not the true and only reasonable conclusion.

I make an order nisi that the Commissioner pay the taxpayer's costs.

(N. J. Barnett)
Judge of the Court of First Instance

Mr. R. J. Faulkner, S. C. for Department of Justice for Appellant.

Mr. Denis Gordon Yu for Baker & Mckenzie for Respondent.