

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D 16/78

Board of Review:

S. V. Gittins, *Chairman*, R. Beynon, K. H. A. Gordon & Maurice P. K. Wong, *Members*.

11 December 1978.

Profits tax – retention of proceeds of sale of goods in U.S. dollars – monies deposited in U.S.A. banks on 7 days call – subsequent conversion to H.K. dollars – loss incurred owing to devaluation of U.S. dollar – whether exchange loss deductible for profits tax purposes.

The appellant company exported goods manufactured in Hong Kong to the United States and was paid in U.S. dollars for the goods. Prior to 12 February 1973 payments so received were deposited in banks in U.S.A. on 7 days call and were remitted to Hong Kong at opportune times when the rates of exchange were favourable for their conversion into Hong Kong dollars. On 12 February 1973 the U.S. dollar was devalued by 10% in terms of gold and the central rate of Hong Kong dollar with the U.S. dollar was adjusted from HK\$5.65 to US\$1.00 to HK\$5.085 to US\$1.00. When finalizing its accounts for the year ended 31 December 1972 the appellant company, being aware of the adjusted rate of exchange, revalued those accounts which were in U.S. dollars and this revaluation resulted in a loss of HK\$327,750.74 in respect of its cash and bank balances, a loss of HK\$9,577.07 in respect of trade debtors accounts, and a loss of \$1,192.00 in respect of interest receivable. For the year of assessment 1974/75 the appellant company deducted from its profits the sum of HK\$333,296 being losses resulting from the devaluation of the U.S. dollars as shown in its accounts for the year 1972.

The assessor disallowed the deduction of the sum of HK\$327,750 in respect of the cash and bank balances. On appeal it was contended on behalf of the appellant company that the cash and bank balances held U.S. dollars were held for trading purpose and therefore the exchange loss was an allowable deduction.

Decision: By majority appeal allowed. Assessment reduced by deduction of the sums of \$327,750 and \$41,584 being exchange losses on cash and bank balances for the years 1972 and 1973 respectively.

The Decision of the Board of Review is subject to appeal to the Court.

H. Litton, Q.C. instructed by Stevenson & Co. for the appellant.

L. J. McKeon for the Commissioner of Inland Revenue.

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Case referred to: -

1. Imperial Tobacco Co. Ltd. v. Kelly, 25 T.C. 292.

Reasons:

1. The Appellant Company has appealed to the Board of Review from a Determination of the Commissioner of Inland Revenue disallowing in the 1974/75 Profits Tax Assessment a claim for loss on balances of U.S. dollars held in the U.S.A. due to the devaluation of the U.S. dollar on 12 February 1973.

2. The facts agreed between the parties are as follows: -

(1) The Appellant Company was incorporated in Hong Kong on the 28 December 1937, and has since been carrying on business in Hong Kong as Exporters and General Merchants. It draws up accounts annually to 31 December in each year. Messrs. Coopers & Lybrand, Chartered Accountants, Certified Public Accountants, are the Company's auditors and tax representatives (the Representatives).

(2) The Company's Profits Tax Return for the year of assessment 1974/75 showed an assessable profit of \$4,199,281, which was arrived at by the making of a number of adjustments to the net profit for the year ended 31 December 1973 as shown in its accounts. Amongst these adjustments are these two items: -

(a) Deduct from Profits: -

Loss resulting from devaluation of United States
dollars (in 1972's accounts, now claimed) \$333,296

(b) Added to Profits: -

Balancing Charge on Furniture, Fixtures and
Equipment \$124,846

(3) On the 19 June 1975, the Assessor raised on the Company a Profits Tax assessment for the year of assessment 1974/75 in the amount of \$6,493,497, computed as follows: -

Profit per Return	\$4,199,281
Add: Profit on Sale of Shares	\$1,966,466

Loss resulting from devaluation of U.S. dollars (cash in hand + cash at bank)	<u>327,750</u>	<u>2,294,216</u>
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Assessable Profit	<u>\$6,493,497</u>
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On the 30 June 1975, the Representatives lodged on behalf of the Company a notice of objection against this assessment on the grounds that “the loss arising on devaluation of United States dollars of \$327,750 has been wrongly disallowed by you as a deduction”.

- (4) On the 12 February 1973, the United States dollars was devalued by 10% in terms of gold. Following this, the central rate of the Hong Kong dollar with the United States dollar was adjusted to HK\$5.085 to US\$1.00 from HK\$5.65 to US\$1.00. When finalizing its accounts for the year ended 31 December 1972, the Company was aware of this alteration of exchange rate, and revalued its cash and bank balances, as well as trade debtors and creditors balances in U.S. currency at 31 December 1972 from HK\$5.68 to HK\$5.10. The result of the revaluation was a net loss of HK\$333,296.76, made up as follows: -

Cash and Bank Balances <u>US\$565,087.49</u>	
@ HK\$5.68	HK\$3,209,696.94
@ HK\$5.10	<u>2,881,946.20</u>
Loss in cash and at bank	327,750.74
Loss in trade debtors accounts	9,577.07
Loss in interest receivable	1,192.00
	338,519.81
Profit in trade creditors accounts	<u>5,223.05</u>
Loss	<u><u>HK\$333,296.76</u></u>

The Company then created a Provision for Loss arising on Devaluation of United States Dollar amounting to \$333,296.76 by a debit to its Profit and Loss Account for the year ended 31 December 1972 and deducted the Provision from the various asset accounts in the Balance Sheet at that date. When computing the assessable profit for the year of assessment 1974/75, the Company took the allowable deduction.

The Assessor took the view that such part of the loss as related to cash and bank balances was not allowable, and disallowed the amount of \$327,750 in assessing the Company.

- (5) On behalf of the Company, it is contended by the Representatives that –
- (a) The funds on which devaluation loss was sustained related to sales proceeds and receipts from trade debtors and were used for paying trade creditors either in U.S. dollars or in Hong Kong dollars when they were so converted. The detailed operation was in the following manner. The Company made a shipment to a customer in the States and drew on the customer a bill in U.S. dollars. Instead of selling the U.S. dollar proceeds to the bank each and every

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time a shipment was made, the Company accumulated those U.S. dollars in various bank accounts. The reasons behind were that on the one hand the Company required U.S. dollars to pay off some of its indebtedness to trade creditors in U.S. dollars, and wished to wait for opportune moments when the rates were favourable for it to sell those U.S. dollars for Hong Kong dollars on the other. Hong Kong dollars so realized were used to pay for purchases in the normal course of business.

- (b) The determining factor in these exchange cases is the intention with which the foreign currency is originally bought; if it is to carry out an intended commercial transaction such as the purchase of consumable stocks, then any profit, however arising, made on the disposal of any surplus foreign currency is of a revenue nature and taxable.
 - (c) It logically follows that, as the U.S. dollars were held for trading purpose, the exchange loss should be allowable.
- (6) In support of their contention the Representatives referred to the British tax case of **Imperial Tobacco Co. (of Great Britain and Ireland) Ltd. v. Kelly**¹, and in particular to the words of Macnaghten J. reported on page 297 –

“The price paid for dollars bought for no other purpose than to pay for tobacco leaf to be used in manufacture by the Company is obviously a trade expense which should be included as a debit in the computation of the annual profits of the trade and it would seem to follow that, if in any year the Company bought more dollars than were actually required and had to sell the surplus, the price received by the Company on any such sale should be credited in the accounts of the trade, with the result that if the surplus dollars were sold at a loss the assessable profits of the trade would, to the extent of that loss, be diminished, and if they were sold at a profit the assessable profits would likewise be increased.”

- (7) Apart from objecting against the assessment for the year of assessment 1974/75, the Representatives also claimed on behalf of the Company correction of an error in the Return for the year under section 70A of the Inland Revenue Ordinance. This claim related to the Balancing Charge on Furniture, Fixtures & Equipment amounting to \$124,846, which the Representatives claimed should have been \$104,645, and submitted a Revised Balancing Charge Schedule to support the claim. This revised figure of \$104,645 has been verified and found correct by the Assessor.
- (8) In the Company's Profit and Loss Account for the year ended 31 December 1973, there was debited under the heading of “Overhead Cost – Administration” a Loss on Exchange of \$27,708. This item is made up as follows: -

¹ 25 T.C. 292.

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Cash and Bank Balance US\$37,918.19

@ Various rates	HK\$234,588.49
@ 5.09	<u>193,003.56</u>
Loss on Cash & Bank Balance	HK\$ 41,584.93
Gain on Trade Debtors	<u>13,877.00</u>
Loss on Exchange	<u>HK\$ 27,707.93</u>

This item was not adjusted in the tax computation supporting the Company's Profits Tax Return for the year of assessment 1974/75.

3. Evidence was given before the Board of Review by the Company's chief accountant at the material time and up to the present.
4. Additional facts found by the Board are as follows: -
 - (1) The Company's business consists mainly of the export from Hong Kong of goods manufactured in Hong Kong.
 - (2) Payment to the suppliers of these goods was in H.K. currency in Hong Kong.
 - (3) Prior to 12 February 1973 in connection with sales to the U.S.A., the Company collected the proceeds of bills drawn on U.S.A. buyers when the bills matured, accumulated such proceeds in U.S.A. banks and eventually remitted them back to Hong Kong at an opportune time. The purpose of such accumulation was that a better exchange rate was likely with a large sum. The U.S. dollar balances were usually put on 7 days call deposit with U.S.A. banks pending their remittance.
 - (4) The U.S. dollar balances were comprised solely of sales proceeds and interest earned on them by being placed on deposit.
 - (5) An insignificant portion of the U.S. dollar deposits was used to discharge the Company's obligations in the U.S.A.
 - (6) After 12 February 1973 the Company changed its policy and henceforth discounted the U.S. dollar bills or sold U.S. dollars forward.
5. The Board finds that prior to 12 February 1973 the Company took a calculated risk on exchange in respect of the U.S. dollar balances kept in the U.S.A. The balances were placed on short term deposits to earn interest during the pendency of the risk.
6. The issue before the Board is whether the claimed loss is a capital loss which is not deductible or a trading loss which is deductible for Profits Tax purposes.

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Decision of Majority of Board

7. The majority of the Board holds that the U.S. dollar balances, being proceeds from the sale of goods and therefore income from trading, did not lose their identity as trading income by being retained in the U.S.A. We hold that the objective of the Company was to remit the U.S. dollar funds to Hong Kong at an opportune time, so that the placing of the funds on 7 days call to earn interest pending their remittance back to Hong Kong did not turn trading income into capital investment.

Decision of minority of Board

8. One member of the Board. Mr. R. Beynon, is of the opinion that the retention of the proceeds of sale in U.S. dollars and the placing of them on deposit altered the nature of the funds from trading income to an investment, so that the loss claimed is a capital loss.

9. The majority decision prevails. The appeal is allowed and the assessment is reduced by the deduction of the deficiencies arising on conversion of U.S. dollars and balances in cash and hand of \$327,750 and \$41,584.