Case No. D35/86

Board of Review:

Robert W. N. Wei, *Chairman*, Lawrence H. L. Fung and C. G. Large, *Members.*

7 October 1986.

Profits Tax—whether exchange gains arising from the translation of Company's assets in foreign currencies into Hong Kong Dollars at year end chargeable to profits tax—whether the gains on disposal of locally quoted shares correctly included in the assessable profits.

The Appellant was incorporated as a private company in August 1973 and in June 1976 it obtained registration as a deposit-taking company. Its principal activities during the relevant period were described as "investment holding, deposit-taking and related financial services".

The Appellant contended that:

(*a*) exchange gains arising from the translation of the Company's assets in foreign currencies into Hong Kong dollars at year end were unrealized book profits which should not be taxable before actual realization;

(*b*) the gains on disposal of locally quoted shares had been incorrectly included in the assessable profits for the years of assessment under dispute because the sale of those shares represented the sale of capital assets;

(*c*) there was no sufficient evidence to support the finding by the Commissioner that the purchase and sale of the locally quoted shares were carried out in the Company's ordinary course of business and were not acquired as long term investments.

Two additional grounds were submitted by the Appellant's representative during the hearing:

(*d*) that exchange gains, whether arising from translation into Hong Kong dollars at year end or from realization at renewal or uplift of Eurodollar deposits were of a capital nature and therefore not taxable;

(*e*) that the interest on its Eurodollar deposits should not be taxed under Section 15(1)(i) of the Inland Revenue Ordinance because the Appellant did not carry on the business of a registered deposit-taking company and that such interest was not business income but investment income.

Held:

(1) The Eurodollar deposit transactions were trading transactions and as such the Eurodollar deposits were trading stock. Where a trading transaction involves, as a necessary incident thereof, the purchase of foreign currency, then any profit or loss resulting from an

appreciation or depreciation of the foreign currency will prima facie be a trading profit or trading loss for income tax purposes as an integral part of the trading transaction.

(2) The profits on sale of locally listed shares were subject to Profits tax in the absence of the intention of holding them as long term investment at the time of acquisition. Short of any change of intention between acquisition and sale one should look to the intention which existed at the time of acquisition.

(3) The interest was business income chargeable to tax under Section 15(1)(i) of the Inland Revenue Ordinance as it arose from deposits transactions which were trading transactions. Although the Appellant took no deposits from the general public it took numerous deposits from a bank, all or a substantial part of which was used to finance its trading transaction.

Appeal dismissed.

Cases referred to:

B.S.C. Footwear v. Ridgway [1971] 2 ALL ER 534.
C.I.R. v. Hang Seng Bank Ltd. 1 HKTC 583.
Davies v. The Shell Company of China Ltd. [1951] 32 TC 133.
Duple Motor Bodies Ltd. v. Ostime 39 TC 556.
Gardner, Mountain etc. v. I.R.C. [1947] 1 ALL ER 650.
Imperial Tobacco Company v. Kelly 25 TC 292.
Lionel Simmons v. C.I.R. 53 TC 461.
Landes Brothers v. Simpson 19 TC 62.
Pattison v. Marine Midland Ltd. [1982] 1 Ch 145; [1983] 1 Ch 205 (CA); [1984] 1 AC 362.
Willingdale v. International Commercial Bank [1978] STC 75.
Whimster v. C.I.R. 12 TC 813.

Wan Tsang Yuk-ling for the Commissioner of Inland Revenue.
A. L. Brown of Price Waterhouse for the Appellant.

Reasons:

Preliminaries

1. The subject of this appeal is the profits tax assessments for the years 1978/79, 1979/80, 1980/81 and 1981/82 of the appellant (the Taxpayer), as revised with respect to the 1978/79 assessment, and confirmed with respect to the subsequent three years, by the Inland Revenue Commissioner.

2. The grounds of appeal stated in the Notice of Appeal dated 3 November 1983 are as follows:—

(*a*) in respect of all years, the exchange gains arising from the translation of the company's assets in foreign currencies into Hong Kong dollars at year end are unrealized book profits which should not be taxable before actual realization. The

unrealized exchange gains have incorrectly been included in the assessable profits for the years of assessment mentioned below.

Year of Assessment	*Unrealized exchange gains* HK$
1978/79	151,701
1979/80	275,085
1980/81	333,192
1981/82	198,060

(*b*) the gains on disposal of locally quoted shares of $1,918,146 and $1,673,619 for 1980/81 and 1981/82 respectively have been incorrectly included in the assessable profits for the years of assessment mentioned above as the sale of these shares represented the sale of capital assets and hence the gains on their realization are of a capital nature and should not be subject to profits tax.

(*c*) there was no evidence or alternatively no sufficient evidence to support the finding by the Commissioner that the purchase and sale of the locally quoted shares were carried out in the company's ordinary course of business and were not acquired as long term investments.

(*d*) the decision of the Commissioner was erroneous invalid and contrary to the provisions of the Inland Revenue Ordinance.

(*e*) the assessments are otherwise incorrect.

During the hearing of the appeal, Mr. Brown of Price Waterhouse the tax representatives of the Taxpayer obtained leave from the Board under Section 66(3) of the Inland Revenue Ordinance to raise some new issues which may be summarized as follows:—

(*f*) That exchange gains, whether arising from translation into Hong Kong dollars at year end or from realization at renewal or uplift of Eurodollar deposits, are of a capital nature and therefore not taxable.

(*g*) That the interest on its Eurodollar deposits should not be taxed under Section 15(1)(i) of the Inland Revenue Ordinance in (i) that the Taxpayer did not in fact carry on the business of a registered deposit-taking company and (ii) that such interest is not business income but investment income.

3. Mr. Brown told us that his firm were appointed the auditors and tax consultants of the Taxpayer as from April 1980. His firm audited the accounts as from 1979/80 onwards.

4. The facts as found by the Commissioner and set forth in paragraph 1 of his Determination of 10 October 1983 (the Determination) are agreed.

Testimony

5. Two witnesses were called on behalf of the Taxpayer. W, senior accountant of PIH, a limited company of which the Taxpayer is a 100% subsidiary, explained some of the exhibits produced by the Taxpayer, such as Exhibits Nos. 5, 7 and 8 which contain an analysis of some 28 Eurodollar deposits made and held by the Taxpayer during the 4 years in question and computations of the exchange gains, both realized and unrealized, arising from these deposits. These exhibits were prepared under her supervision and were all based on the Taxpayer's books and records, notably the general ledger. She was first employed by PIH at the end of 1984, and was therefore unable to give direct evidence of the Taxpayer's operations during the accounting period.

6. The second witness G was the managing director of the Taxpayer until mid-1981 when he had to be replaced by his wife on account of his seat in the B Stock Exchange. However, he acted as the general manager of the Taxpayer for the remainder of the accounting period. PIH is owned as to 70% by his father (or presumably his estate after his death on 14 October 1983) and other members of his family. He stated that although the Taxpayer got registered as a deposit-taking company (DTC), it never in fact operated as a DTC, the reason being that he was looking for a big financial institution for a partner and that without the support of such a partner, deposits taken would not be "stable" enough. In buying shares, he stated that the Taxpayer always looked to high yield as the criterion. It sold most of its locally listed shares in 1980/81 and 1981/82 because he thought the shares had gone too high, and dividend income at the prevailing price levels was no longer attractive. After 1981/82, the Taxpayer did not buy local shares any more because he did not have much confidence in the future of Hong Kong. In fact, he stated that before Mrs. Thatcher's visit to Peking in September 1982 he had already assumed that the New Territories lease would not be renewed in 1997. He stated that all the shares purchases were long term investments. The shares sold in 1978/79 were sold by his father during his absence from Hong Kong and he did not know why his father should have sold them. However, it was also his father's policy to buy shares as long term investments. He says he did not realize that the auditors had included the profit made on the sale of these shares in 1978/79 as taxable income in the tax computations until the day before he was called to give evidence. In 1983/84 he says he tried to sell the Taxpayer because he had not been able to find a partner although there had been negotiations for that purpose. He stated that the Taxpayer's status as a DTC was cancelled in 1985. He stated that the Taxpayer's loans were taken in Hong Kong dollars whilst the offshore deposits were made in US dollars. He stated that he was educated in the United States, and that he was influenced by what he understood to be the position in the United States, and thought that if one held shares for a year any profit on resale would be a capital gain. He stated that he thought the same applied to Hong Kong and that if he sold shares in Hong Kong after holding them for one year, any profit that he would make on the resale would be tax free.

7. In cross-examination by Mrs. Wan for the Revenue, he said that he made all the decisions for the Taxpayer except during periods of absence from Hong Kong. He has some business interests in California. General speaking, he is away from Hong Kong in the summer months every year. The Taxpayer bought shares only for dividend income, and all the share purchases were long term investments. He would do some analysis before making a purchase. He did not act on rumours. He said his father signed the balance sheet for 1978/79 and another director signed the profits tax return for that year. He agreed that dividend income from the locally listed shares bought by the Taxpayer was less than the interest expense paid for financing the purchases, but he thought that interest income from the US dollar deposits was higher than the interest expense. He said that in November 1980 he applied on behalf of the Taxpayer for 10 000 shares in H Bank Ltd. and was allotted 3 000 shares. He stated that was also for long term investment. He said the amount was small but the idea was to obtain the balance sheet of the company through being a shareholder. He said that he did not remember, but upon being shown Appendix C6 to the Determination, he accepted that on 25 November 1980, i.e., five days after the purchase, he sold the shares for $14,000 making a 33% profit. In re-examination he said the general manager of the bank was a friend, but he did not induce G to apply for the shares. He says in purchasing shares he was guided by two considerations, i.e., yield and his understanding that profit on resale of shares held for one year would be tax free.

8. The Taxpayer was incorporated as a private company on 10 August 1973. On 30 June 1976, it obtained registration as a deposit-taking company (DTC) under the Deposit-taking Companies Ordinance, Cap. 328. It commenced business on 1 April 1977. Its principal activities during the relevant period are described by its tax representatives as “Investment holding, deposit-taking and related financial services”. (The Determination, para 1(2) and (3)).

9. It appears that in 1977/78 the Taxpayer made a currency purchase of US$400,000 financed by a bank overdraft of over HK$1.8 million and lent the US dollars to a bank in London in the form of what is commonly known as a Eurodollar deposit. (Appendix H, page 1) The deposit was rolled over at maturity when the principal and interest were compounded to form the principal of a new deposit. This new deposit was again rolled over at maturity. The deposit was in all rolled over twelve times for varying periods at varying rates of interest until 4 September 1981 when the last deposit matured and was uplifted, i.e., repaid. (Exhibit 5—Deposit No. 2) The Eurodollar deposits subsequently made by the Taxpayer were also rolled over in a similar manner. A further Eurodollar deposit equivalent to HK$93,700 was made in 19 August 1977. (Exhibit 5—Deposit No. 3) As for shares, purchases totalling $1.37 million (including locally listed shares totalling $770,000) were made in that year. (The Determination, para 1(12) & (13)).

10. In 1978/79, the Taxpayer made three Eurodollar deposits equivalent to HK$1.01 million. (Exhibit 5—Deposits Nos. 1, 4 and 5) shares purchases totalled $5.92 million. During the same year, the Taxpayer sold most of the locally listed shares it had purchased within the previous twelve months making a profit of $556,000 and purchased local and overseas shares at a total cost of $5.92 million of which $2.56 million was the cost of locally

listed share. The paid up capital of the Taxpayer for 1978/79 was $2.5 million, the minimum required by the Deposit-taking Companies Ordinance. The bank overdraft stood at $6.47 million at year end.

11. In 1979/80, the paid up capital was increased to $5 million by an injection of new capital of $2.5 million. In addition there was dividend income of about $250,000. $1.34 million of the new capital was paid up by the transfer of four Eurodollar deposits from PIH to the Taxpayer. (Exhibit 5—Deposits Nos. 11–14) The Taxpayer made twelve more Eurodollar deposits equivalent to HK$3.14 million. (Exhibit 5—Deposits Nos. 6–10 and 15–21) It purchased only locally listed shares at a total cost of $385,000. There were no share disposals during that year. Bank loan and overdraft stood at $7.88 million at year end, whilst the amount due to the holding company was $2.2 million.

12. In 1980/81, thirteen Eurodollar deposits equivalent to over HK$5 million was uplifted at maturity. On the other hand the Taxpayer made two Eurodollar deposits equivalent to HK$435,000. On the shares front, it sold most of its locally listed share holdings for $2.63 million, making a profit of $1.86 million. It also bought some locally listed shares in small quantities totalling $94,000. There was also some movement in unquoted shares and shares listed overseas. The result of these transactions was that the total indebtedness was reduced from $10 million to $2.8 million.

13. The year 1981/82 saw the same pattern. Eleven Eurodollar deposits equivalent to HK$5.84 million were uplifted at maturity, whilst six new Eurodollar deposits equivalent to HK$2.23 million were made. As for shares, no substantial purchases were made whilst disposals totalled $2.4 million, producing a profit of $1.67 million. As a result, indebtedness to the bank was reduced to $26,000.

"Long Term Investment"

14. In 1978/79 and 1979/80 when the Taxpayer was building up its holdings in both Eurodollar deposits and shares (including locally listed shares), bank loan or bank overdraft stood at $6.47 million and $7.88 million at year end respectively. This means that it was relying on bank credit to support 67% and 50% respectively of its holdings. G says these assets were pledged to the bank as security for the credit. However, the fact remains that to a very substantial degree the Taxpayer was holding its assets on borrowed money. G agrees that the bank has the right to call for repayment on demand but there was no evidence to show that the bank promised or bound itself in any way not to ask for the money back for any agreed length of time. In these circumstances, it seems unlikely that the Taxpayer would have had an intention to hold all these assets on a long term basis as and when it acquired them.

15. The Taxpayer's case before the Board is that all its Eurodollar deposits and share purchases were long term investments and therefore that the exchange gains arising from these deposits and the profits on the sale of the shares are all of a capital nature and not taxable. It is settled law that an asset must be either trading stock or long term investment at

any given time, and that there must be a corresponding intention to hold the asset one way or the other. In the absence of any change of intention between acquisition and sale, the relevant intention is that existing at the time of acquisition. (Lionel Simmons v. CIR 53 TC 461 at 491–2). So the Taxpayer's case is essentially that it had the intention to hold all these assets as long term investments as and when it acquired them. We do not think this is consistent with G's evidence about his or his father's intention in launching the Taxpayer. From the very beginning, he stated, the intention was to find a big financial institution for a partner, because his family alone would not command sufficient public confidence to make any deposits "stable". Although no deposit was taken from the general public, the Taxpayer used the letterhead in the name of the company in its business correspondence and maintained the statutory minimum paid up capital of a registered DTC. The intention, as we find, was to start taking deposits from the general public as soon as a partner had been found. Negotiations went on with interested parties for them to join the Taxpayer. Although such negotiations failed in the end in 1983/84, the fact remains that, throughout the accounting period, the Taxpayer's investment arrangements were made pending a successful conclusion of these negotiations and therefore, we think, were subject to adjustments and alterations as the new management might have required. Again, from this point of view, it seems unlikely that the Taxpayer would have had an intention to hold all these assets as long term investments at the times of the respective acquisitions.

Eurodollar Deposits

16. Insofar as the Eurodollar deposits are concerned, it must be pointed out that before the Commissioner the Taxpayer was content to argue that only realized exchange gains are taxable and that since the exchange gains in question are unrealized book profits, they are not taxable. By necessary implication, until the hearing of this appeal, the Taxpayer had accepted that the Eurodollar deposit transactions were trading transactions. If it is true that the Taxpayer made its Eurodollar deposits as long term investments, they should not have been classified as current assets in the balance sheets, nor should the exchange profits have been brought into the profit and loss accounts. The expression "current asset" is interchangeable with "circulating capital asset". Whilst profits from the realization of a fixed capital asset are not receipts on revenue account, profits from the realization of circulating capital assets are receipts on revenue account. (Halsbury's Laws of England, 4th ed., Vol. 23, para 288). The Taxpayer now seeks to go back on the classification adopted in the four years' audited accounts, which the auditors (who were also the Taxpayer's tax consultants for the years 79/80 to 81/82) in their reports to the shareholders described as giving a true and fair view of the state of the Taxpayer's affairs. We must assume that the audited accounts were duly approved by the board of directors. We are not saying that in no circumstances can a taxpayer be allowed to go back on its approved audited accounts, but clearly cogent evidence is required to explain how the alleged incorrectness arose. In this case what needs to be explained is why the Eurodollar deposits were put in the category of current assets, and why the profits were brought into the profit and loss accounts. The Taxpayer adduced no evidence on this score. If the Taxpayer made its Eurodollar deposits as long term investments, it must have had a corresponding intention at the time when each

of these deposits was made. One would have expected the Taxpayer to give instructions to its auditors and tax consultants regarding such intention. To categorize the deposits as current assets is to say that they are trading stock. We cannot imagine that the audited balance sheets would have shown the deposits as current assets or that the exchange gains would have been brought into the profit and loss accounts had the auditors and tax consultants been informed that the Taxpayer's intention was to hold them as long term investments.

17. For all these reasons we find that the Eurodollar transactions are trading transactions and that the Eurodollar deposits are trading stock.

Unrealized Profits

18. That disposes of ground (*f*) of this appeal as paraphrased in paragraph 2 above. The Taxpayer relies on ground (*a*) in the alternative, i.e., that if the Eurodollar transactions, are trading transactions, the exchange profits arising from the translation of the Eurodollars into Hong Kong dollars at year end are unrealized book profits which should not be taxable until actual realization.

19. Ground (*a*) is based on a line of authorities of which the leading authority is BSC Footwear v. Ridgway [1971] 2 All ER 534 HL where Lord Reid has this to say at 536:—

> "… it is well settled that the ordinary principles of commercial accounting must be used except insofar as any specific statutory provision requires otherwise. The question is what is fair to the taxpayer and fair to the revenue.
>
> It has long been recognized that a fair result cannot be achieved without taking into account the trader's stock-in-hand at the beginning and at the end of the year …
>
> 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 …
>
> The principle is subject to an exception as regards stock-in-trade. If it were applied logically, stock-in-trade must always be valued at the end of the year at cost, even if it could have been bought at the end of the year must more cheaply. But for half a century at least traders have been allowed to value such stock at the end of the year at its market price or market value at that date if that is lower than the original cost price: on the other hand, the trader is not required to value his stock at market value if that is higher than the original cost … That exception has been expressed by the phrase 'cost or market value, whichever is the lower' …"

Lord Reid was in a minority in that case but the above dicta did not form any part of the disagreement, and were applied in the later case of Willingale v. International Commercial Bank [1978] STC 75 HL, where Lord Keith of Kinkel says at 86:—

> "The argument for the Crown started from the statement of Lord Haldane in Sun Insurance Office v. Clark (Surveyor of Taxes):

> 'It is plain that the question of what is or is not profit or gain must primarily be one of fact, and of fact to be ascertained by the tests applied in ordinary business. 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.'

It was accepted that, in the words of Lord Reid in BSC Footwear Ltd. v. Ridgway (Inspector of Taxes):

> '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.' …

The latter group of cases establish that it may be right in principle to bring into credit in a particular accounting year something which will not be received until a later year, and likewise to bring into debit an expenditure which will not require to be made until a future year, and further that it may be correct to strike the appropriate credit or debit by a process of estimation or of discounting. The principle which justifies this is that the receipt has been earned by services rendered or goods supplied in the earlier year, or that the liability for the expenditure arises from some transactions in the earlier year, and it is not a necessary objection to the inclusion in the account of the receipt or expenditure in question that it is uncertain, deferred or contingent …"

20. Ground (*a*) is directed at the Eurodollar deposits current at year end. The profits arising from translation into Hong Kong dollars at the date of the balance sheet are not taxable, the Taxpayer argues, because such gains can only be realized at maturity. However, as Lord Keith of Kinkel pointed out, the cases establish that it may be right in principle to bring into credit in an accounting year something which will not be received until a year later because the receipt has been earned by services rendered or goods supplied. In our view the present case is such a case. The Eurodollars were supplied upon the making of each deposit, and the Taxpayer has earned a right to payment of the same amount of Eurodollars plus the agreed interest. In Gardner, Mountain, Etc. v. IRC [1947] 1 All ER 650 HL, Viscount Simon says at 653–4:—

> "… In calculating the taxable profit of a business on income tax principles, … services completely rendered or goods supplied which are not to be paid for till a subsequent year cannot, generally speaking, be dealt with by treating the taxpayer's outlay as pure loss in the year in which it was incurred and bringing in the remuneration as pure profit in the subsequent year in which it is paid, or is due to be paid … the net result of the transaction, setting expense on the one side and a figure for remuneration on the other side, ought to appear, (as it would appear in a proper system of accountancy) in the same year's profit and loss account, and that year will be the year when the service was rendered or the goods delivered…. This may involve, in some instances, an estimate of what the future remuneration will amount to (and in theory, though not usually in practice, a discounting of the amount to be paid in the future) …"

Viscount Simon refers to a discounting of the amount of the future payment which is not usually required in practice. In the present case, the deposits were all for short terms ranging from one week to six months. Further it is not suggested by the Taxpayer that a discounting

is required in practice in these circumstances. We therefore take the view that the full amount of principal and interest of each deposit should be brought into account.

21. The principle of bringing into account a future payment which has been earned has been applied in cases where the payment is not in a foreign currency and so there is no question of any exchange gain or loss arising. But there is authority for the proposition that where a trading transaction involves, as a necessary incident thereof, the purchase of a foreign currency, then any profit or loss resulting from an appreciation or depreciation of the foreign currency will prima facie be a trading profit or trading loss for income tax purposes as an integral part of the trading transaction. This was agreed by both parties as correctly stating the law in Davies v. The Shell Company of China, Ltd. (1951) 32 TC 133, and was approved by Jenkins L. J. in the same case where he says at 151, "That concession or admission (i.e., the proposition above state) by Mr. Grant (for the company) is amply justified by the cases to which we have been referred (i.e., Lands Brothers v. Simpson 19 TC 62 and Imperial Tobacco Company v. Kelly 25 TC 292)." The Taxpayer did not question the correctness of this principle. We see no reason why it should not apply to the present case.

The Lower of Cost and Exchange Rate

22. There is another limb to ground (*a*), namely, that as a corollary of the principle that no profit can be anticipated, the Eurodollar deposits current at year end should not be valued at the rate of exchange prevailing at the date of the balance sheet because there is no actual conversion of the Eurodollars into Hong Kong dollars at that date, but should be valued at that exchange rate or the cost of each deposit, whichever is the lower, in accordance with the method referred to by Lord Reid in the BSC Footwear case. In that case, the stock-in-trade was shoes. In the other two cases relied on by the Taxpayer, i.e., Whimster v. CIR 12 TC 813 and Duple Motor Bodies Ltd. v. Ostime 39 TC 556, it is equally clear that the court did not apply its mind to foreign currency assets. We are not aware of any authority for saying that the lower of market value or cost method should apply to foreign currency assets.

23. On the contrary, there is no lack of evidence that foreign currency assets are valued in practice at the rate of exchange prevailing at the balance sheet date. In Pattison v. Maring Midland Ltd. [1982] 1 Ch 145; [1983] 1 Ch 205 (CA); [1984] 1 AC 362, the taxpayer company carried on an international banking business, providing short term and medium term finance, mainly in US dollars. The main part of its trading income consisted of the excess of the interest received from its customers on loans and deposits in US dollars over the interest it paid on loans and deposits in US dollars. The borrowing and lending transactions were matched in a book maintained for US dollar transactions. The general aim of the company was to ensure that at any particular time the total of its monetary assets (principally loans and deposits made by it) denominated in a foreign currency was equal to the total of its monetary liabilities (principally loans and deposits received) denominated in that foreign currency. In practice the company achieved at least 95% matching in any particular foreign currency 90% of the time. However, the company had an occasional open position in a foreign currency. It the foreign currency appreciated or depreciated against

sterling while this unmatched foreign currency asset was held, its value in terms of sterling would increase or decrease as the case may be. The amount of the increase or decrease would be treated as an exchange profit or loss falling to be brought into the company's profit and loss account, which was expressed in sterling. The company's practice was as follows. For balance sheet purposes, foreign currency assets and liabilities were translated into sterling at the spot rate of exchange at the balance sheet date. Any differences arising from these translations were credited or debited to the profit and loss account as exchange profits or losses, as the case might be. This practice was agreed by both parties as a proper method of accounting in international banking and appropriate in ascertaining assessable profit. In 1976 the company repaid all the borrowings from its existing dollar funds. Before the repayment, the borrowings were not converted into sterling. The dispute was over the fact that in relation to the matched transactions, nothing was brought into the profit and loss account for changes in their sterling values. The Revenue contended that the notional profits on the matched transactions arising from the depreciation of sterling against the US dollar were liable to tax. It was held by the House of Lords that the company realized no actual exchange profit since it made no relevant currency conversion and that, accordingly, it made no taxable profit from the lending and repayment of the US dollar borrowings save for the interest differential.

24. The ratio decidendi in the Pattison case is that throughout the process of borrowing, lending and repayment, only one currency was involved, and that since no currency conversion was made, no exchange profit was made. In the present case there are no matched foreign currency transactions. The borrowing were in Hong Kong dollars; the lendings were in Eurodollars; and the repayment were again in Hong Kong dollars. So the actual decision in the Pattison case is not relevant. What is relevant is the evidence of a practice, agreed by both parties to be a proper method of accounting, of translating foreign currency assets and liabilities into sterling at the spot rate of exchange at the balance sheet date.

25. In the Pattison case, Vinelott J at first instance says at [1982] 1 Ch 171:—

> "… The rule that current assets must be brought in at whichever is the lower of cost or realizable market value is not an inflexible one, and where, as here, the stock in trade of a company is foreign currency I can see nothing wrong in bringing current assets and liabilities into account at market value measured by current rates of exchange. There was no evidence before the commissioners that any other way of drawing the accounts would have been commercially acceptable or indeed practicable, and if one is entitled to speculate it must be doubtful whether accounts could have been drawn on the basis of historic cost."

The validity of the learned judge's dictum is not affected by the decision in the House of Lords.

26. The editors of Simon's Taxes 3rd ed. on the subject of exchange profits or losses have this to say at B 3.1101:

> "As a result of changes in rates of foreign exchange, profit or loss may arise in sterling terms. It is a general principle that where the profit or loss arises in the course of trading operations, it is taxable as trading income."

They also comment on the effect of the decision in the Pattison case as follows:—

> "A profit or loss may arise as a result of changes in the relative values of the foreign currency and sterling—
>
> (*a*) where there is an actual exchange of currency by the taxpayer; or
>
> (*b*) where there is a foreign currency balance owed by or to the taxpayer which is unmatched by other transactions by the taxpayer in that currency."

27. In CIR v. Hang Seng Bank Ltd. HKTC 582, the taxpayer company adopted the same practice of bring into the profit and loss account all exchange profits arising from the balance sheet date conversions to the Hong Kong dollar value of the taxpayer's circulating capital in foreign currencies. This method of accounting was approved by Huggins J., as he then was, when he says at 592:—

> "As I see it, the profit which is being taxed takes into account the notional increase or decrease in the value in Hong Kong of the currency held. This itself is an artificial view of the true state of affairs because while the currency remains abroad it cannot in one sense increase in value 'in Hong Kong'. However, such assets could be disposed of in Hong Kong and it is both sensible and normal commercial practice to value them in this way. If one did not do so the bank might increase its stock-in-trade outside the Colony and never be taxable on the increase until, possibly many years later, the currency was brought back to Hong Kong and disposed of. That would be convenient neither to the Revenue nor to the taxpayer."

28. In drawing up its accounts, the Taxpayer followed the same practice. "… At the balance sheet date, assets and liabilities in foreign currencies are translated at the exchange rates ruling at that date. All exchange gains and losses are included in the determination of profits." (The Determination, para 1(6))

29. The Hong Kong Society of Accountants' statement of Standard Accounting Practice 2.111 states in paragraphs 21 and 22 as follows:—

> "21. At each balance sheet date monetary assets and liabilities denominated in a foreign currency should be translated using the closing rate or, where appropriate, the rates of exchange fixed under the terms of the relevant transactions.
>
> 22. … An exchange gain or loss will also arise on unsettled transactions if the rate of exchange used at the balance sheet date differs from that used previously. Such exchange gains and losses should be included in the profit or loss from ordinary activities unless they arise from events which themselves fall to be treated as extraordinary items, in which case they should be included as part of such items."

In paragraph 38, 1 January 1985 is named as the date from which the accounting requirements including those stated in paragraphs 21 and 22 take effect. But, as referred to above, there is evidence that this practice was in existence well before that date.

30. The Practice of valuing foreign currency assets at the exchange rate prevailing at the balance sheet date has been followed and approved by the courts both in England and in Hong Kong. True, the Taxpayer is not a bank, but foreign currency is its trading stock, and we see no reason for saying that this practice should not apply to the valuation of its Eurodollar balances. That answers ground (*a*) of this appeal.

Share Disposals

31. Grounds (*b*) and (*c*) in paragraph 2 have to do with the profits on the sale of locally listed shares for 1980/81 and 1981/82, the central argument here is that all such shares were acquired as long term investments and that the profits were capital gains. Here, the Taxpayer is once more up against the audited accounts. The profits in question were brought into the profit and loss accounts, and the Taxpayer has not offered any evidence that this treatment was incorrect. We feel that if G had given instructions to the auditors and tax representatives that these were long term investments, the profits would not have been included in the profit and loss accounts. As mentioned above, an assets must be either trading stock or long term investment at any given time, and there must be a corresponding intention to hold the asset in one way or the other. Short of any change of intention between acquisition and sale, one should look to the intention which existed at the time of acquisition. (Lionel Simmons v. CIR 53 TC 461 at 491–2)

32. G, in the course of giving his evidence, repeatedly stressed that all share purchases were long term investments. As his testimony progressed, it became clear, however, that by a long term investment he meant a holding lasting for a year or more and that at all material times his understanding was that if one held at share for a year or more, any profit made on resale would be tax free as a capital gain. His repeated assertion that all the share purchases were long term investments is therefore of little assistance to the Taxpayer’s case in view of his apparent misapprehension about what a long term investment is.

33. We are concerned with the profits made on the sale of locally listed shares in 1980/81 and 1981/82. The records show that by far the greatest majority of these shares were purchased in 1978/79. (Appendices C and D to the Determination)

34. In 1978/79 the Taxpayer also sold most of the locally listed shares it had purchased within the previous twelve months making a profit of $153,811 (representing a 53% excess over cost) which the Taxpayer’s representatives agreed was taxable as the shares were short term investments and were purchased and disposed of within one year. (The Determination, para. 1(15)(i)(*b*)). G’s evidence is that generally speaking he was away from Hong Kong during the summer months every year and the 1978/79 sales were made by his father during his absence in September 1978. He says it was also his father’s policy to buy shares as long

term investments, and he does not know why his father sold these shares. G offered no explanation of this rather strange lack of communication between father and son as to the reason for selling the shares. He did not realize, he says, that the former auditors had included the profit on the sale of these shares as taxable income in the tax computations until the day before he was called to give evidence. This statement, surprising as it may be, lacks point in reality because G does not deny knowledge of the original agreement by the present tax representatives that the profit is taxable, nor does he deny the authority of the tax representatives for making the agreement. 1979/80 was a relatively quiet year with purchases totalling $385,000 only and no sales.

35. The big pay-off came in 1980/81 and 1981/82 when the Taxpayer sold locally listed shares most of which had been bought in 1978/79 and cleared a 250% profit amounting to $1.91 million and $1.67 million respectively. G's explanation is that the prices had gone up too much and that dividend income was no longer attractive. But dividend income was never attractive. When he was cross-examined on his alleged policy of investing for dividend income, G could not give a satisfactory answer to the question why buy for dividend since, as he agreed, dividend would be exceeded by the interest on the borrowings used to finance the purchase. His position was further weakened by the evasive manner in which he spoke about the H Bank shares which were sold five days after allotment at a 33% profit. Although the transaction was relatively small in amount, it does in our view point to the true intention of the Taxpayer in the matter of buying and selling locally listed shares.

36. The shares sold in 1980/81 and 1981/82 were for the greatest part bought in the year 1978/79, which saw considerable action in both buying and selling. The sales in 1978/79 were agreed to be trading transactions and taxable. We find that the agreement was made by the tax representatives with the full authority of the Taxpayer and that the intention of the Taxpayer in buying the shares in 1977/78 and 1978/79 (which it resold in 1978/79) was to resell at a profit. That being so, we have no reason to think that in 1978/79 when it bought the shares which were later sold in 1980/81 and 1981/82, the Taxpayer had a different intention. True, some of the shares bought in 1978/79 were in the same companies as some of the shares sold in 1978/79, and there were no further sales until 1980/81. However in all the circumstances we do not think that is proof of an intention to hold the purchases as long term investments. We find that the Taxpayer's intention in acquiring the shares in 1978/79 was, as before, to resell at a profit. The Taxpayer made the point that all the shares bought were registered in the Taxpayer's name. We do not think that carries the matter one way or the other. After all it is common knowledge that it only takes a few weeks to effect registration. For all these reasons we find that the profits on the sale of locally listed shares in 1980/81 and 1981/82 are subject to profits tax.

Interest

37. The additional ground (*g*) in paragraph 2, which is in two limbs, raises the point that interest on the Eurodollar deposits are not taxable under Section 15(1)(i) of the Ordinance. The relevant words of the legislation are "arising through or from the carrying on by the

financial institution of its business". The first limb is that the interest is not business income but investment income because the Eurodollar deposits are long term investments. In view of our finding that the deposits are trading transactions, that limb fails. The other limb is that the words "its business" mean a business of taking deposits and that the interest did not arise through or from the carrying on by the Taxpayer of a business of taking deposits because it never took deposits from the general public. We think one must first look at the definition of the word "deposit" in Section 2 of the Deposit-taking Companies Ordinance Cap. 328 which reads, as far as relevant, as follows:—

> " 'deposit' means a loan of money at interest or repayable at a premium or repayable with any consideration in money or money's worth …"

The word "depositor" is defined as a person entitled or prospectively entitled to repayment of a deposit. Thus when a registered DTC takes a loan or overdraft from a bank, it is taking a deposit. We have found that both the making of the Eurodollar deposits and the purchase of locally listed shares are trading transactions. The Taxpayer, a registered DTC, from 1977/78 to 1979/80, took numerous deposits from a bank, all or a substantial part of which was used to finance its trading transactions. The deposit-taking activity of the Taxpayer in these circumstances should in our view be regard as a business of taking deposits even though it never took deposits from the general public. We arrive at this conclusion on the basis that the Taxpayer's interpretation of Section 15(1)(i) is correct. But is it correct? The Taxpayer contends that "its business" means in the present context a business of taking deposits. We think that interpretation is too narrow. The obvious question one would ask is, if that is what the Legislature meant, why does it not say so? The plain ordinary meaning of the expression is, we think, the business actually carried on by the financial institution. Whether interest can be said to arise through or from the carrying on of the business depends on the nature of the business. If a registered DTC, such as the Taxpayer, refrains from taking deposits from the general public for lack of a robust partner, contents itself with borrowings from banks, intending, however, to extend the scope of its borrowings to deposits from the general public once it has secured the support of a partner, and in the meantime converts part of the borrowings into Eurodollar deposits to generate interest income, we think such interest should be regarded as arising through or from the carrying on by the registered DTC of its business. The Taxpayer cited the case of Northend v. White etc. 50 TC 121. We can derive no assistance from the case which turned on quite different wording. The question there was whether the interest income was immediately derived by a solicitor from the carrying on by him of the profession of solicitor, whilst here the question is whether the interest income arose through or from the carrying on by the Taxpayer of its business whether it is a business of taking deposits or not. For these reasons, we are of the view that the interest on the Eurodollar deposits in this case is taxable under Section 15(1)(i).

Conclusion

38. It follows that this appeal is dismissed and that the Profits Tax Assessments for the years 1978/79 to 1981/82 as revised and confirmed by the Commissioner are hereby confirmed by the Board of Review.