Case No. D36/86

Board of Review:

H. F. G. Hobson, *Chairman*, Ronald Arculli and G. C. Docherty, *Members.*

4 November 1986.

Profits Tax—whether unrealized exchange gains shown as profits in the accounts of a registered deposit-taking company taxable pursuant to Section 14 of the Inland Revenue Ordinance.

The Appellant is a registered deposit-taking company in Hong Kong. Its principal activities are trade financing and deposit-taking and prepares its accounts in Hong Kong dollars. Out of a total exchange gain reflected as a profit in the year end accounts, approximately one-fifth were gains actually realized and the remaining four-fifths arose from the translation purely for balance sheet purposes of certain US Dollar deposits, credits and bills of exchange into Hong Kong dollars.

Held:

The unrealized gains were no more than a translation into local currency to present a fair view of the Company's affairs at the balance sheet date and are not taxable. That the time and call deposits and the bills of exchange formed part of the taxpayer's stock-in-trade and they should be valued at the lower of cost or market value and need not be subjected to any special valuation.

Appeal allowed.

Cases referred to:

B.S.C. Footwear Ltd. v. Ridgway [1972] AC 544.
C.I.R. v. Hang Seng Bank Ltd. 1 HKTC 583.
C.I.R. v. Jebson & Co. 1 HKTC 8.
Duple Motor Bodies Ltd. v. Ostime [1961] 39 TC 556.
Pattison v. Marine Midland Ltd. [1984] STC 10.
Whimster & Co. v. C.I.R. [1925] 12 TC 813.
Willingale v. International Commerce Bank Ltd. [1978] 52 TC 242.
Dennis O'Dwyer for the Commissioner of Inland Revenue.
Patrick Paul of Price Waterhouse for the Appellant.

Reasons:

1. Are unrealized exchange gains shown as profits in the accounts of a deposit-taking company taxable pursuant to section 14 of the Inland Revenue Ordinance? That is the question central to this appeal.

2. The basic facts are as follows:—

2.1 The Taxpayer, is a registered deposit-taking company in Hong Kong. Its principal activities are trade financing and deposits-taking. It was incorporated in Hong Kong on 30 March 1976 and was registered under the Deposit-taking Companies Ordinance on 23 June 1976.

2.2 The Taxpayer prepares its accounts in Hong Kong dollars. It adopts the following accounting policies in relation to transactions in foreign currencies:—

> "Transactions arising in foreign currencies during the year are converted at exchange rates approximating those ruling at the transaction dates. Foreign currency balances at the year end are translated at rates of exchange approximating those ruling at the balance sheet date. All exchange differences are dealt with in the profit and loss account."

2.3 Out of a total exchange gain of $662,212 reflected as a profit in the accounts of the Taxpayer for the year ended 31 March 1983, $136,793 were gains actually realized—which the Taxpayer did not dispute were taxable—the balance of $525,419 arose from the translation purely for balance sheet purposes of certain US dollar deposits, credits and Bills of Exchange into HK dollars at year's end.

An analysis of this *unrealized* exchange gain is as follows:

Unrealized exchange gain on US dollar deposits placed	$560,645
Unrealized exchange loss on US dollar deposits accepted	(35,226)
Net unrealized exchange gain—	$525,419

3. To get to grips with the legal issue involved—for the matter seems to us to turn upon legal interpretation—we propose to summarize the Commissioner's reasons for concluding that the net unrealized exchange gain concerned was caugut by s. 14.

First, the Taxpayer's own annual accounts showed the gain as profitable income,

Secondly, as a general principle those accounts serve as the basis for computing taxable profits, except where specific adjustments are required by legislation; the treatment of the gain in those accounts accords with generally accepted accounting principles and practice,

Thirdly, the Commissioner considered certain dicta in CIR v. Hang Seng Bank Ltd. (HKTC 583) as supporting the view that notional (as opposed to actual) profits are taxable,

Fourthly & Fifthly, Pattison v. Marine Midland Ltd., relied upon by the Taxpayer, in fact favours the view that exchange gains were taxable.

4. Mr. Y, a director of the Taxpayer familiar with its exchange transactions, gave evidence.

4.1 Mr. Y confirmed the facts at 2 above and explained that in calculating the profit or loss when translating the US dollars credits held by the Taxpayer at end of its accounting year it would adopt the difference in the rate used when translating the US dollars at the opening of the year of account (which perforce would be the rate for closing of the previous year's accounts) which was HK$6 to one US dollar and the rate applicable at the year's end which was HK$6.60 per US$1; a difference of 60 HK cents.

4.2 The balance of the Taxpayer's US dollar *assets and liabilities* as at 31.3.83 were as follows:

(*a*)	M Trust Co—A/C No. 1	$ 816.65
(*b*)	M Trust Co—A/C No. 2	132,623.85
(*c*)	M Trust Co—Term deposit TDC 02 (Contract dated 21.3.83, maturity 21.6.83)	750,000.00
(*d*)	Interest receivable	2,512.29
(*e*)	Bills receivable	48,456.59
(*f*)	Deposits received	(57,821.41)
(*g*)	Interest payable	(889.16)
		$875,698.81

4.3 The largest favourable resulting balances were therefore (*b*) and (*c*) (total US$882,623) of which (*b*) was a call account.

4.4 The result therefore for 4.2(*c*) above was a gain of HK$450,000 (i.e. US$750,000 × HK0.60 cents). Thus the greater part of the HK$525,419 unrealized exchange gain resulted from the notional conversion of the US$750,000.

4.5 Back tracking to show how the US$750,000 came about, Mr. Y told us that on the 1 April 1982 the Taxpayer had about US$4,700,000 in the call account. Of that amount:—

(i) US$300,000 was subsequently transferred from call to a term deposit (and was subsequently consolidated with other monies to form part of the US$750,000) where it remained throughout the account year,

(ii) US$450,000 was used during the account year to purchase at a discount bills of exchange, the proceeds from which when they matured were first credited to the call account then when they aggregated US$450,000 that amount was also placed on time deposit (whether by addition to the existing time deposit or by separate deposit is not material). At the end of the year US$48,456.59 (item (*e*) of 4.2) in discounted bills was still in hand; and

(iii) the balance (US$4.7 m. less US$300,000 and US$450,000) of $3,950,000 was either sold during the year and the gain brought into tax or partially went to eliminate US dollar liabilities.

The US dollars at (i) and (ii) were placed on deposits with varying maturities and rolled over for subsequent periods as they matured: the fact that US$750,000 at 4.2(*c*) has only one deposit number suggests that the US$300,000 and the US$450,000 were amalgamated: either on the 21.8.83 or at some time earlier.

4.6 As to item 4.2(*b*)—US$132,623.85—this was the balance standing to the credit of the call account at the end of the year and the Taxpayer applied the same HK$6.60 when translating that sum into HK dollars.

4.7 The same criterion was used to translate items (*a*) and (*d*) to (*g*) of 4.2 into HK dollars.

4.8 We have referred only to the call account No. 2 but conceivably some or even all of the monies at 4.5(i) and (ii) came from the account 4.2(*a*)—but we do not think the point is material.

4.9 Mr. O'Dwyer examined Mr. Y at some length on the propriety of using the criterion at 4.1.

4.10 We understood Mr. Y's evidence to amount to this:—

(*a*) If the Taxpayer had US dollars in hand at the beginning of the year and *sold* some (or all) *during* the course of *the year* then the difference between the accounting year's commencement rate and the sale rate (or the *average* of the sales rates, assuming more than one sale) would determine whether there was a profit or loss and would be so treated for tax purposes. An *average* would be used because it would be impossible (or at any rate impracticable) to match any given dollar (which in any case was no more than a US dollar receivable due from Manufacturers Hanover, not the physical notes) with the dollars held

at beginning of the year. It did not matter that those US dollars had been bought in the preceding year at a rate greater or less than the rate ruling on the 1 April because the closing balance on the 31 March would itself have adjusted the figure up or down (see (*b*) below).

(*b*) If the Taxpayer purchased US dollars during the year and had *some* or *all in hand at the end of the year* then the year end accounts would show as a notional loss or gain the difference between the *average* of the actual purchase prices and the ruling rate at the end of the year.

(*c*) If the Taxpayer *purchased* and *sold* US dollars *during the year* it would adopt the average of the rates respectively for the purchases and the sales. This system of comparison was fair and reasonable because there were several purchases at different rates and several sales in amounts not corresponding to any given purchase.

5. We can see nothing inherently wrong with system referred to at 4.10 indeed para 19 of Statement 2.111 (to which we refer later) appears to endorse the system. Perhaps a first in first out system could be adopted as an alternative but we are inclined to think that it could be more controversial since unlike the average system if no sales (hence no "first out") were made during the year the accounts would show no *notional* profit or loss at the end of the year thus the accounts would not even pretend to reflect the value at the year's end.

6. Of passing interest only Mr. O'Dwyer acknowledged that there was nothing in law—nor would it seem in accountancy practice—which requires a Hong Kong company to present its annual accounts in Hong Kong dollars (at least since the relevant Defence Regulations were repealed); indeed we suppose some companies do so, for there are a few incorporated with share capitals in foreign currencies.

7. We now turn to the cited cases which in chronological order are:—

Whimster & Co. v. CIR (1925 12 TC 813)
CIR v. Jebsen & Co. (1949 HKTC p. 8)
Duple Motor Bodies Ltd. v. Ostime (1961 39 TC 556)
BSC Footwear Ltd. v. Ridgway (1972 AC 544)
CIR v. Hang Seng Bank Ltd. (1972 HKTC 583)
Willingale v. International Commerce Bank Ltd. (1978, 52 TC 242)
Pattison v. Marine Midland Ltd. (1984 STC 10 HL)

7.1 As to the first and second of the Commissioner's reasons, Mr. O'Dwyer referred us to the latest Statement of Standard Accounting Practice No. 11 ("Statement 2.111") of the HK Society of Accountants relating to Foreign Currency translations. However we do not consider that the mere act of adopting those recommendations, of itself, turns a notional profit into a taxable one. The recommendations are surely aimed at laying down uniform treatment for annual

accounts for all companies thus, inter alia, enabling those interested to compare one company's results with another.

7.2 Mr. Paul viewed the Commissioner's second reason at 3. above as permitting only legislative exceptions and in response cited the following remark (our emphasis) by Lord Reid (p. 524) in the BSC Footwear case:

> "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. A trader may have made such a good contract in year 1 that is virtually certain to produce a large profit in year 2. But he cannot be required to pay tax on that profit until it actually accrues. And conversely he may have made such an improvident contract in year 1 that he will certainly incur a loss in year 2, but he cannot use that loss to diminish his liability for tax in year 1."

We believe this is further justification for concluding that the Commissioner's second reason was faulty.

7.3 Reference was made in pre-objection correspondence to an extract from a passage in Simon's Taxes. The following is the text from which the extract is taken:

> "Further difficulties arise on the treatment of unrealized gains or losses, where trading profits in foreign currency arise to a United Kingdom resident company trading overseas, or the overseas branch of a United Kingdom resident company. Where such a company's accounts are kept in foreign currency and converted into sterling, a fluctuation in the prevailing rate of exchange may produce an unrealized gain or loss, appearing as an entry on the face of the final accounts. As a general principle, the treatment for tax purposes will be influenced by the accounting treatment adopted, but there are two major alternative methods, each subject, in practice, to minor variations.
>
> The first alternative is known as the 'profit and loss account' method. The adjusted profit for tax purposes is converted to sterling at the average rate of exchange prevailing throughout the relevant accounting period, or at the rate prevailing at the closing balance sheet date. *Tax computations remain unaffected with one major exception. The actual exchange profits and losses on subsequent remittances of cash profits from overseas are included in the tax computations of accounting periods in which such remittances occur. These profits or losses are measured by comparing the exchange rate applied to the actual remittances with the average (or, if applicable, closing balance sheet) rate previously adopted.*
>
> The second method is known as the 'balance sheet' method. Where this applies, current assets and liabilities, that is stocks, debtors, creditors and cash balances are valued at opening and closing balance sheet dates at the exchange rate then prevailing. The differences arising on fluctuation of exchange rates are treated as taxable gains or allowable losses. Similar profits or losses on conversion of fixed assets are not, of course, so treated, so that it may become important to distinguish

> fixed from current assets; that is, fixed capital from circulating capital. This principle derives its authority from the 'Golden Horseshoe' case, in particular, the doctrine that changes in circulating capital must be taken into account in ascertaining annual profits.
>
> Where accounts are submitted to the Revenue in sterling, the balance sheet method will normally be adopted, but the Revenue place most emphasis on consistency of treatment over the lifetime of a business."

7.4 The extract however ignored the second paragraph (wherein the italic is ours). If the second paragraph is a correct statement of the law (as distinct from UK Inland Revenue practice) and our law is the same and (as seems to us to be the case) the Taxpayer's accounts were drawn up along the lines of the first alternative then the Taxpayer's unrealized gains would not be taxable.

However neither the Commissioner nor Mr. O'Dwyer referred to this passage from Simon's Taxes, nor for that matter did Mr. Paul. We must therefore press on with consideration of the other legal arguments.

7.5 The question was posed as to whether the Taxpayer's deposits and presumably its Bills of Exchange are part and parcel of its stock-in-trade (the question arises out of a review of the Hang Seng Bank case). If they are then, Mr. Paul submits, they should be valued at the lower of cost or net realized value (authority for this proposition abounds—Lord Reid's statement at p. 524 of the BSC Footwear case is but one citation). Consequently as the deposits are unrealized at year's end the accounts would merely reflects the rate at the time of purchase hence no gain would appear in the accounts.

Mr. O'Dwyer argued that currency is a special case (despite the fact that the Hang Seng case was concerned with currencies) and in support referred us to Statement 2.111 and compared it to Statement 2.103 (which deals with the treatment of stocks and work in progress). We confess that we did not comprehend this argument—particularly as in paragraph 2 "stocks and work in progress" is said to comprise "goods or other *assets* purchased for resale": granted deposits are not normally purchased for resale (certificates of deposits however are an obvious exception) in the accepted sense yet the deposit certificate must be produced on maturity at which point the Bank buys back this evidence of indebtedness. Whether in Hong Kong a Bank can be said to "sell" Hong Kong dollars in return for its customer's cash cheque is perhaps doubtful, but when it hands over US dollars for HK dollars it certainly sells the US dollars. Conversely when the Taxpayer originally bought US dollars it can reasonably be supposed that at some time it would sell at least some of those (as it did) to buy HK dollars.

On balance we are inclined to agree with Mr. Paul on this aspect. But in case we are wrong we press on.

7.6 The Statement by Sir Leslie Gibson C.J. in the Jebsen case that "profits, for the purposes of the Business Profits Tax, are actual profits not book profits" was not unnaturally seized upon by Mr. Paul for the unrealized gains were no more than a translation from one currency to another for book purposes. Lord Salmon in the Willingale case said "It is well established … that a profit may not be taxed until it is realized. This does not mean until it has been received in cash but it does mean until it has been ascertained and earned …" (p. 269).

7.7 The House of Lord's decision in Willingale's case in our opinion fully supports Mr. Paul's argument, at lease in so far as the bills of exchange referred to in 4.2(*e*) are concerned.

Briefly, ICB discounted bills issued by various borrowers throughout the world which generally were held to maturity (one to 10 years.) In its annual accounts, ICB showed profits using a time based proportion of the profit the Company expected to receive if held to maturity. The Revenue, assessed these book profits to tax.

—The General Commissioners held for ICB and the following two passages (with emphasis added by us) deserve attention:

"For *I.C.B. it was accepted* that the *audited accounts* of I.C.B. *showed a true and fair view* of the profit of the year *in accordance with accountancy principles*, but it was contended that for the purposes of income tax and corporation tax the bringing into the balance sheet of estimated values of '(interest and) discount receivable' was contrary to the principles of tax law in that it anticipated profit which was not realizable until maturity or sale of the bills or notes. The *Inspector agreed* that this *method of ascertaining* I.C.B.'s profits *was in accordance with accountancy principles and contended that it should be followed for tax purposes.*

We have considered the cases cited to us and accept the contention on behalf of I.C.B. that the *principle to be followed for taxation purposes is that profits are not to be taxed until realized and that if in ascertaining profits on a true and fair view the principles or practices of commercial accountancy conflict with this principle*, they are *not to be followed.* We find on the evidence before us that it was not possible for I.C.B. to realize before maturity the discount on the discounted bills and notes otherwise than by sale on the market. We are of the opinion that it is not open to us to disregard the nature of the discounted bills and notes and we reach the *conclusion that the inclusion by I.C.B. in its accounts of the unrealized appreciation in the value of bills and* promissory notes is *not in accordance with the principles of income tax law* for the computation of profits and that *no part of the anticipated profit on maturity falls* to be *included* in the *computation of the profits of I.C.B. for corporation tax purposes* for the years of assessment before us."

(*Note:* it is clear from the Commissioner's summary that ICB argued that the Bills were stock-in-trade, this aspect is not dealt with later in the decision or any judgments.)

—The Crown appealed unsuccessfully to the Chancery Division.

—Then again to the court of Appeal where the Crown failed once more (of the 3 judges two were for dismissal and one, Stamp L.J., dissented).

—Undeterred, the Crown turned to the House of Lords where three of their Lordships were for dismissal, one dissented for the same reasons expressed by Stamp L.J., the other for reasons expressed at length).

The reasons for the above recital is to show that six out of nine of the judges endorsed the finding of the General Commissioners after a very thorough review of case law and tax accounting treatment. We do not think it is necessary to examine the reasoning by which the majority of Law Lords reached their decision—we think that the following quotation (our emphasis) at p. 272 from Lord Fraster of Tullybelton, referred to by Mr. Paul, will suffice:—

> "The solution to the problem depends in my opinion upon the true nature of what the Bank is doing when it discounts or purchases a bill. In my view *it is acquiring an asset and, so long as it continues to hold that asset, it does not, and cannot, realize any profit or loss in respect of it*. If the Bank takes credit for any 'accrued discount' while it is still holding the bill, it is therefore anticipating a profit that has not yet been realized. If the bills were ordinary commodities there can be no doubt that would be the position, and I cannot see that it makes any difference for this purpose that the bills were for fixed sums of money. Of course, the fact that the money value at maturity is fixed means that the Bank could ascertain in advance the profit that it would make if a bill is held to maturity. But we know that it quite often did not do so but sold bills before maturity. In such cases the realized profit would be unlikely to be exactly the same as the profit expected on maturity, and the sale might even be at a loss. Even where bills were held to maturity a substantial *number of them were in currencies other than sterling* and *fluctuations* in the foreign exchange rates *would therefore affect the sterling value* and the *profit on maturity* of such bills."

Mr. O'Dwyer referred to certain remarks of Stamp. J. but as those were not accepted by his fellow judges in the Court of Appeal or the majority in the House of Lords we do not consider the reference valid.

7.8 So far then as this Taxpayer's unrealized Bills of Exchange are concerned, we consider that Willingale is overwhelming authority for excluding them from taxable profits—whether one is talking of the profit which the Taxpayer hopes will accrue between the discounted purchase price of those bills (it is not clear to us whether the US$48,456.59 at 4.2(*e*) included this or is simply a statement of the purchase price) or the notional exchange gain (or both).

7.9 (*a*) The conclusion at 7.8 still leaves open the question of whether the deposits (and for that matter US dollars standing to the credit of the call account) should be treated in the same way. Certainly Bills of Exchange are fundamentally different from time deposits not least because in England and Hong Kong they have their own regulating legislation, wherein the definition clearly excludes time deposit receipts. That however does not mean that the principle in Willingale is necessarily inapplicable.

(*b*) Bearing in mind the second sentence of the passage from Lord Fraser's judgment referred to at 7.7 above and the fact that his Lordship considered that for the purpose of deciding how discounted bills should be viewed in the context of that case, they were indistinct from Bills of Exchange, we are inclined to the view that Time Deposits should receive the same treatment as Bills.

Moreover as a general rule Time Deposits cannot be sold, nor can the holder require the issuing bank to redeem them, before maturity, hence Lord Fraser's remarks are even more pointed in the case of deposits.

7.10 The Hang Seng case is concerned with whether on the devaluation of sterling in 1967 the Hang Seng Bank was entitled to set off the loss vis-a-vis Hong Kong dollars—against its taxable profits. At the heart of the issue was whether bearing in mind that the *interest* on those deposit was *not taxable*, the exchange loss on the deposits giving rise to that interest could be treated as a revenue loss. The Court concluded that it was nonetheless eligible because the sterling held by Hang Seng was its stock-in-trade and consequently it fell to be valued at year's end at the lower of cost or market (though the judgment did not express it in this fashion).

It is obvious that the facts embraced unrealized losses—"In November 1967 the bank held quantities of sterling and US dollars. In the same month the United Kingdom government devalued the pound sterling" (Huggins J. p. 589)

Both sides referred to various passages in the judgment of Huggins J. (as he then was) as supporting their respective contentions, the Revenue particularly relying on a passage on p. 592 concerning the *notional* increase or decrease in the value in Hong Kong dollars of the foreign currency held, viz "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 foreign 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". We do not think this lends support to the proposition that consequently book profits become taxable.

Mr. O'Dwyer remarked upon the havoc that would be wreaked for the Revenue if foreign currencies remained unconverted for a number of years: in doing this Mr. O'Dwyer referred to another passage in Huggins J.'s judgment but that passage was concerned with whether it was right and proper to value the foreign currency holding at the lower of market or cost and having concluded the deposits were stock-in-trade the judge endorsed the normal valuation treatment. In any event Mr. O'Dwyer's remark is blind to the fact that in keeping the currency unconverted a taxpayer runs the risk of an actual loss which could wipe out the intervening years of book profit on the one hand or of realizing a substantial taxable profit which could well result in greater taxes being exacted due to an increase in base rates (rarely do tax rates decline) than if intermediate book increases were brought into charge to tax.

7.11 Whatever other conclusions may be drawn from the Hang Seng decision it is clear that a bank's foreign currency deposits should be treated as stock-in-trade.

We therefore look upon this decision as very favourable to Mr. Paul's argument summarized at 7.5 above.

Nevertheless Mr. O'Dwyer persevered, so must we—for despite Willingale and Hang Seng—he still had argumentative ammunition in his locker.

7.12 Pattison v. Marine Midland is concerned with an unusual state of affairs for it would seem that the UK taxpayer bank had devised a means—through the issuance of US dollar loan stock to its US parent the proceeds of which were placed upon US dollars deposits—to overcome certain minimum liquidity requirement laid down for banks. The loan stock was, of course, a capital liability: when the bank redeemed it with US dollar deposits, the sterling equivalent of which had depreciated, the House of Lords held that the depreciation constituted a capital, not a trading, loss. Whilst this summary of the case is inadequate for considering the ratio decidendi therein, it is, we think, sufficient to show that the circumstances of the case are so far removed from those of the case before us as to be of no direct assistance.

7.13 The cases of Whimster and the Duple were cited by Mr. Paul as judicial authority for the proposition that stock-in-trade is to be valued at the lower of cost or market value at the end of the accounting year. Mr. O'Dwyer did not dispute this proposition, he merely sought unsuccessfully to convince us that the foreign currency balances were in a different category from other types of assets.

8. We are therefore drawn irresistibly to the opinion that the "unrealized gains" were no more than a translation into local currency to present a "fair view" of the Company's affairs and are not taxable. The Taxpayer would of course be entitled to declare a dividend based upon such book profit and pay that dividend if its cash from other quarters (such as reserves) enabled it to do so, nonetheless the character of the underlying asset would not change.

However should we be wrong in this respect we would nevertheless hold, as a matter of fact, that the time and call deposits and the bills of exchange formed part of the Taxpayer's stock-in-trade. Of these two approaches we believe the first to be the correct approach.

9. On the basis of the rationale set out in paras 7.2, 7.3 and 7.6, we think the first and second reasons referred to in paragraph 4 are misconceived, that the third para is unsupported, as a valid reason, by the obiter dictum in the Hang Seng case and the reliance on Pattison is not justified having regard to the distinguishing features of that case.

10. Accordingly this appeal is allowed.