Case No. D54/91

Profits tax – calculation of carry forward losses – taxpayers accounts maintained in foreign currency – whether losses to be calculated and carried forward in Hong Kong Dollars.

Panel: William Turnbull (chairman), Erwin A Hardy and Peter F Rhodes.

Date of hearing: 4 September 1991.
Date of decision: 28 October 1991.

The taxpayer was an overseas company carrying on business as an airline. It operated a branch in Hong Kong. The accounts of the taxpayer were maintained in an overseas currency and the branch in Hong Kong maintained its accounts in the same currency. For very many years, the taxpayer had not been assessed to tax in Hong Kong because either it had incurred losses or the amount of its profits were less than the amount of its carry forward losses. The taxpayer maintained that because it kept its accounts in a currency other than Hong Kong dollars, the amount of its carry forward losses should be calculated in the foreign currency and carry forward in that currency without converting into Hong Kong dollars. The Commissioner maintained that at the end of each year, the profit or loss of the taxpayer should be ascertained and the amount converted into Hong Kong dollars and the resulting Hong Kong dollar loss carry forward in Hong Kong dollars and the resulting Hong Kong dollar loss carry forward in Hong Kong dollars to the next succeeding year when the same calculation would be made. Because of fluctuations between Hong Kong dollars and the foreign currency used by the taxpayer, the result of adopting the method of calculation used by the Commissioner meant that the carry forward losses were substantially less after being converted into Hong Kong dollars and carry forward than they would have been if they had remained in the foreign currency concerned. In respect of the year in question, the assessor assessed the taxpayer to tax on the basis that all of the carry forward losses had been off set against taxable profits and there was a net profit liable to be assessed to tax. The taxpayer appealed to the Board of Review.

Held:

The taxpayer was correct in calculating its carry forward losses in its own foreign currency and not converting the same into Hong Kong dollars.

Appeal allowed.

[Editor's note: The Commissioner of Inland Revenue has filed an appeal against this decision.]

Cases referred to:

Payne v Deputy Federal Commissioner of Taxation [1936] AC 497
Pattison v Marine Midland Limited 57 TC 219
Sharkey v Wernher [1956] AC 58

Jennifer Chan for the Commissioner of Inland Revenue.
Denis O'Dwyer of Ernst and Young for the taxpayer.

Decision:

This is an appeal against by an overseas company against a determination of the Commissioner in which he refused to revise the manner of calculating the carry forward loss of the company. The facts were not disputed and are as follows:

1. The Taxpayer was a company incorporated outside of Hong Kong and at all relevant times carried on the business of transport and the provision of related services.

2. The Taxpayer operated a branch of its company in Hong Kong and the branch in Hong Kong received substantial revenue from customers of the Taxpayer in Hong Kong.

3. The Taxpayer maintained its principal accounts in the currency of the country where it was incorporated, 'the base currency', and likewise the branch which it operated in Hong Kong kept its principal accounts in the same overseas currency. Other currencies were converted into the base currency at least monthly and the branch, whenever necessary or appropriate, would remit or receive funds to or from the parent company.

4. Pursuant to the Inland Revenue Ordinance, the Taxpayer was subject to profits tax to be calculated in accordance with the provisions of section 23C of the Inland Revenue Ordinance which provides that the assessable profits for any year of assessment shall be a portion of the total worldwide profits of the Taxpayer calculated in accordance with the provisions of the Inland Revenue Ordinance.

5. In addition to maintaining its audited accounts in the base currency, the branch of the Taxpayer prepared and filed profits tax returns and profits tax computations in the base currency and not in Hong Kong dollars.

6. Starting with the year of assessment 1972/73, the branch of the Taxpayer filed tax returns which in most years showed a loss but in some years showed a profit. The tax returns were accepted by the assessor and starting with the year of assessment 1972/73, the assessor ascertained that there was a net carry forward loss (after deducting any profits) in respect of each of the years of assessment up to the year of assessment 1988/89. The assessor duly informed the Taxpayer of the amount of the accumulated carry forward loss each year as ascertained by the assessor but the figure as determined by the assessor was never agreed or accepted by the Taxpayer. As the amount of losses calculated by the assessor on a carry forward basis always exceeded whatever profits there might be for assessment, it was neither necessary for the Taxpayer nor did the Taxpayer under the provisions of the Inland Revenue Ordinance have the right to challenge the carry forward calculations of the assessor. However, in the years of assessment 1987/88 and 1988/89, the Taxpayer made substantial profits and the profits for the year of assessment 1988/89 exceeded the amount of the then available carry forward losses as calculated by the assessor.

7. The method of calculation of the carry forward loss adopted by the assessor in respect of each year was to take an appropriate rate of exchange for the year of assessment in question and to convert the amount of that year's carry forward loss into Hong Kong dollars which so far as the assessor was concerned was the final and fixed sum of the carry forward loss in Hong Kong dollars and which was then added to the amount in Hong Kong dollars of the balance of the previous carry forward losses. Whenever there was a taxable profit in any year of assessment the same was likewise converted into Hong Kong dollars by applying an appropriate rate of exchange and the Hong Kong dollar amount was deducted from the then balance in Hong Kong dollars of the carry forward losses.

8. On the other hand, the Taxpayer which maintained its accounts in the base currency did not convert its losses for taxation purposes in Hong Kong into Hong Kong dollars but carried them forward in the base currency. When a profit was made it would or could be offset against the base currency loss by either direct offset or making conversions at the same rate of exchange of the profit and so much of the carry forward loss as might be necessary, the result being the same.

9. During the period from the year of assessment 1972/73 to the year of assessment 1988/89 the rate of exchange between the base currency and Hong Kong dollars fluctuated substantially. The result of these fluctuations was that if the carry forward losses were calculated and maintained in the base currency and not converted into Hong Kong dollars on an annual basis and then carried forward in Hong Kong dollars, there would still have been substantial carry forward losses in the year of assessment 1988/89. If calculated and maintained in the base currency, there would be a carry forward loss of $3,689,122 after

allowing for the full amount of the attributable taxable profits for the years of assessment 1987/88 and 1988/89. On the other hand, if the losses were converted into Hong Kong dollars at the appropriate rate each year and carried forward in Hong Kong dollars, there would have been a net assessable profit for the year of assessment 1988/89 of HK$10,138,389.

10. The calculation as made by the Taxpayer for the carry forward losses calculated and maintained in the base currency was as follows:

Year of Assessment	Profit (loss) per return (base currency)	Loss carried forward (base currency)
1972/73	(6,742,941)	(6,742,941)
1973/74	(793,999)	(7,536,940)
1974/75	197,630	(7,339,310)
1975/76	(341,239)	(7,680,549)
1976/77	(2,808,964)	(10,489,513)
1977/78	454,768	(10,034,745)
1978/79	1,879,643	(8,155,102)
1979/80	(3,216,046)	(11,371,148)
1980/81	(3,451,436)	(14,822,584)
1981/82	(7,649,373)	(22,471,957)
1982/83	(3,360,746)	(25,832,703)
1983/84	3,881,113	(21,951,590)
1984/85	5,087,784	(16,863,806)
1985/86	3,327,743	(13,536,063)
1986/87	(1,624,755)	(15,160,818)
1987/88	5,941,070	(9,219,748)
1988/89	5,520,626	(3,689,122)

11. The carry forward losses and the assessable profits for the year of assessment 1988/89 would have been as follows, if calculated according to the procedure of the assessor:

Year of Assess-ment	Profit (loss) per return in base currency dollars	Exchange Rate	Assessable profits (loss) HK$	Net assessable profits after loss set off HK$	Loss carried forward HK$
1972/73	(6,742,941)	2.02	(13,620,740)	Nil	(13,620,740)
1973/74	(793,999)	2.07318	(1,646,102)	Nil	(15,266,842)
1974/75	197,630	2.10625	416,258	Nil	(14,850,584)

1975/76	(341,239)	1.998	(681,795)	Nil	(15,532,379)
1976/77	(2,808,964)	1.894	(5,320,177)	Nil	(20,852,556)
1977/78	454,768	1.919	872,699	Nil	(19,979,857)
1978/79	1,879,643	2.082	3,913,416	Nil	(16,066,441)
1979/80	(3,216,046)	2.2787	(7,328,404)	Nil	(23,394,845)
1980/81	(3,451,436)	2.3016	(7,943,825)	Nil	(31,338,670)
1981/82	(7,649,373)	2.4779	(18,954,383)	Nil	(50,293,053)
1982/83	(3,360,746)	2.7	(9,074,014)	Nil	(59,367,067)
1983/84	3,881,113	3.3162	12,870,547	Nil	(46,496,520)
1984/85	5,087,784	3.256	16,565,824	Nil	(29,930,696)
1985/86	3,327,743	3.148	10,475,735	Nil	(19,454,961)
1986/87	(1,624,755)	3.0025	(4,878,326)	Nil	(24,333,287)
1987/88	5,941,070	3.084	18,322,259	Nil	(6,011,038)
1988/89	5,530,626	2.92	16,149,427	10,138,389	Nil

12. The Taxpayer failed to submit its profits tax return for the year of assessment 1988/89 within the stipulated period and the assessor raised on the Taxpayer an estimated assessment as follows:

Estimated profits for 1988/89	HK$16,149,427
Less: Loss set off (see below)	6,011,038
Estimated assessable profit	HK$10,138,389

Statement of Loss

Loss brought forward [as previously notified the loss notices (Form IR87A) forwarded to the Taxpayer each year]	HK$6,011,038
Less: Loss set off	6,011,038
	Nil

13. The Taxpayer through its tax representatives objected to the profits tax assessment on the ground that it was excessive and a profits tax return for the year of assessment 1988/89 together with a profits tax computation was filed by the Taxpayer to validate the objection. This profits tax return and profits tax computation showed the assessable profits of the Taxpayer for the year of assessment 1988/89 as being $5,530,626 base currency units which when converted at the appropriate rate of exchange of HK$2.92 = 1 base currency unit was equal to the amount of HK$16,149,427 being the amount in Hong Kong dollars which the assessor had assessed to tax in his estimated assessment. However, the Taxpayer proposed that the amount of $5,530,626

being the assessable profit should not be converted into Hong Kong dollars but should be deducted from the carry forward loss in base currency units which according to the Taxpayer's calculations at that date amounted to $9,219,748 base currency units which would leave $3,689,122 base currency units to be carried forward as available losses for deduction against profits in future years.

14. The Commissioner by his determination dated 10 May 1991 rejected the objection by the Taxpayer and upheld the assessor's assessment.

15. The Taxpayer filed notice of appeal against the Commissioner's determination to this Board of Review.

At the hearing of the appeal, the Taxpayer was represented by its tax representative. As stated above, there was no dispute with regard to the facts which were agreed by both parties. It was confirmed by the representative for the Commissioner that it was agreed that the Taxpayer had maintained its principal accounts in Hong Kong in the base currency. It was further confirmed that the worldwide audited accounts of the Taxpayer which were used to ascertain the worldwide profit of the Taxpayer were maintained and audited in the base currency and that the profits tax computation prepared according to section 23C of the Inland Revenue Ordinance was likewise prepared in the base currency. A copy of the Taxpayer's worldwide audited accounts and tax computation for the year ended 31 March 1989 were tabled before the Board of Review and it appeared clear that it would have been difficult and probably impossible to have used any other currency than the base currency.

It was common ground between the parties that the taxable profits (or losses) of the Taxpayer were governed by section 23C of the Inland Revenue Ordinance which reads as follows:

> ' 23C. Ascertainment of the assessable profits of a non-resident ship-owner
>
> (1) Where a person to whom the provisions of section 23B do not apply carries on a business as an owner of ships and any ship owned or chartered by him calls at Hong Kong such person shall be deemed to be carrying on that business in Hong Kong, and the assessable profits from such business for any year of assessment shall be the sum bearing the same ratio to the aggregate of the sums receivable during the basis period for such year of assessment by such person in respect of the carriage of passengers, mails, livestock and goods shipped in Hong Kong, in respect of outward towage undertaken from Hong Kong and in respect of charter hire attributable to a permanent establishment maintained by such person in Hong Kong as his total profits for the basis period bear to the aggregate of the total sums receivable by him during that period in respect of the carriage of passengers, mails, livestock and goods, in respect of towage and in respect of charter hire:

Provided that in calculating the sums receivable in respect of the carriage of passengers, mails, livestock and goods shipped in Hong Kong nothing shall be included in respect of the shipment of goods brought to Hong Kong solely for transshipment unless the outward freight is payable in Hong Kong.

(2) Where in the opinion of the assessor the provisions in sub-section (1) for computing assessable profits cannot for any reason be satisfactorily applied in the case of any particular person, the assessable profits of such person for any year of assessment may be computed on a fair percentage of the aggregate of the sums receivable during the basis period for such year of assessment by such person in respect of the carriage of passengers, mails, livestock and goods shipped in Hong Kong, in respect of outward towage undertaken from Hong Kong and in respect of charter hire attributable to a permanent establishment maintained by such person in Hong Kong:

Provided that where the profits of any person have been assessed for any year of assessment in accordance with this subsection, such person shall, notwithstanding the provisions of section 70, be entitled to claim at any time within two years of the end of such year of assessment that his assessable profits for that year be recomputed on the basis provided by sub-section (1) of this section.

(3) Where the Commissioner is satisfied that the call of a ship owned or chartered by a person to whom the provisions of this section apply is casual and that further calls at Hong Kong by that ship or others in the same ownership are improbable, he may in his discretion direct that such person shall not be deemed to be carrying on business in Hong Kong by reason of such casual call.

(4) The master of any ship owned by a person to whom the provisions of this section apply shall, though not to the exclusion of any other agent, be deemed to be the agent of such person.

(5) In this section-

"business as an owner of ships" does not include dealing in ships or agency business in connection with shipping;

"charter hire" means sums receivable by a ship-owner under a charter party which is either a bare boat, voyage or time charter and under which there is a demise of the ship;

"owner" includes a charterer;

"permanent establishment" means a branch, management or other place of business, but does not include an agency unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of his principal;

"ship" includes aircraft;

"total profits" for any period means the world profits of a person from his business as an owner of ships as shown by his accounts for such period:

Provided that where the said total profits have been computed on a basis which differs materially from that prescribed in this Part for the ascertainment of assessable profits in respect of which a person is chargeable to tax, such profits shall be adjusted so as to correspond as nearly as may be to the sum which would have been arrived at had they been computed in accordance with the provisions of this Part relating to the ascertainment of assessable profits in respect of which a person is chargeable to tax.

(6) For the purposes of this section, a sum receivable by a ship-owner under a charter party other than a bare boat, voyage or time charter under which there is a demise of the ship, shall be taken to be receivable from the carriage of passengers, mails, livestock and goods or in respect of towage.'

In summary what section 23C of the Inland Revenue Ordinance says is that where a freighter is carrying on its business in Hong Kong, it is taxed on a notional profit which is a part of its worldwide profits which part is calculated in the ratio which its Hong Kong income bears to its total worldwide income. In making the calculation, it is necessary to restate the profits of the Taxpayer to conform with Hong Kong taxation principles in particular in relation to the calculation of depreciation allowances. The application of section 23C is quite complex and a lengthy tax computation is required but the principle is simple and straight forward. In algebraic terms, the calculation can be written as follows:

$$\frac{\text{Hong Kong Receipts}}{\text{Worldwide Receipts}} \times \text{World Adjusted Profits}$$

The representative for the Commissioner pointed out that when assessing profits, it was necessary to convert into Hong Kong dollars at the appropriate rate of exchange, the answer to the foregoing algebraic question. She pointed out that assessments to tax in Hong Kong could only be issued in Hong Kong dollars and could not be issued in

foreign currencies. Accordingly, she said that for each year of assessment, it was necessary to ascertain the profits according to the algebraic formula, convert the resultant sum into Hong Kong dollars, and then issue the relevant assessment in Hong Kong dollars, which would then be paid in Hong Kong dollars.

With this summary of the procedure, the tax representative for the Taxpayer did not take any objection and likewise we, as the Board of Review, consider that it is the correct procedure to adopt where there is a taxpayer maintaining its accounts in an overseas currency and which carries on a business in Hong Kong which is subject to assessment under section 23C of the Inland Revenue Ordinance.

Section 23C of the Inland Revenue Ordinance relates to assessing profits and not calculating losses.

A combination of section 19 and section 19C of the Inland Revenue Ordinance provide that where a loss is made in any year of assessment such loss shall be carried forward until it is fully utilised by being off-set against future profits. A change in the law took place at the end of the year of assessment 1974/75 but for the purposes of this appeal, the change is not material and for the sake of simplicity, we are not setting out the two sections in full.

Section 19A of the Inland Revenue Ordinance is the relevant section which provides how section 19 losses are to be computed. Sub-section (1) of section 19A is the relevant sub-section and reads as follows:

> ‘ 19A(1) For the purposes of section 19, the amount of a loss incurred by a person chargeable to tax under this Part shall, subject to the provisions of sub-section (2) of this section, be computed in a like manner as assessable profits are computed.’

Section 19D of the Inland Revenue Ordinance refers to the computation of losses after 3 April 1975 which are covered by section 19C and reads as follows:

> ‘ 19D(l) For the purposes of section 19C, the amount of loss incurred by a person chargeable to tax under this Part for any year of assessment shall be computed in like manner and for such basis period as the assessable profits for that year of assessment would have been computed.’

Though there are some differences in wording between section 19A(1) and section 19D(l), for the purposes of this appeal the two sub-sections have the same meaning which is that losses are to be computed in like manner and for the same basis period as assessable profits.

There is no dispute between the Taxpayer and the Commissioner as to the computation of the losses over the years in the base currency. It is agreed or accepted by the Commissioner that as the Taxpayer maintains its principal accounts in the base currency, it is either necessary or convenient to use the base currency both for the computation of assessable profits and for the computation of tax losses.

The only disagreement between the Taxpayer and the Commissioner is on a very small but very important point relating to the conversion of the losses from the base currency into Hong Kong dollars. The representative for the Commissioner put forward a very cogent argument that because assessable profits are assessed each year in Hong Kong dollars, therefore, tax losses must likewise be computed and converted into Hong Kong dollars and carried forward in Hong Kong dollars. In effect, she was saying that in normal circumstances where a profit is made, a tax assessment is issued in Hong Kong dollars, paid in Hong Kong dollars and that is then an end of the matter. The tax affairs of the taxpayer have been concluded once and for all in respect of that year of assessment. In the next following year, the taxpayer starts with a clean sheet and the assessable profits are again computed and are then assessed and taxed in Hong Kong dollars. She pointed out that under sections 19A and 19D of the Inland Revenue Ordinance, losses are to be computed in like manner to assessable profits and she went on to say that this means that a loss must be computed for the year of assessment in question, converted into Hong Kong dollars, and then remain in Hong Kong dollars at that figure. This submission has a certain logic about it.

The representative for the Taxpayer pointed out that though it may have a certain logic, a distinction must be drawn between computing profits and losses and issuing assessments. He pointed out that he did not dispute that a tax assessment must be in Hong Kong dollars and must be paid in Hong Kong dollars. The Hong Kong dollar is the official and lawful currency of Hong Kong and the Hong Kong government cannot operate in other currencies. However, the assessment to tax is nothing more than that, it is an assessment. On the other hand, the computation of the profit is a different operation to the issuing of the assessment and the computation of the profit takes place in whatever is the appropriate currency which is not necessarily Hong Kong dollars and in the case before us was the base currency. In the course of the hearing, it was pointed out that many businesses maintain their accounts in currencies other than Hong Kong dollars and it is necessary to compute the assessable profits in such currencies. It is only after the profit has been computed that the profit can be and is converted into Hong Kong dollars for the purpose of issuing an assessment. The representative for the Taxpayer pointed out that losses should be computed in the same manner as assessable profits but as there is no profit to be assessed, it is inappropriate to convert the amount at the end of each year into Hong Kong dollars and carry it forward in Hong Kong dollars. It should remain in the base currency.

In the course of his making his submission, the representative for the Taxpayer referred us to two decisions of the highest authority, namely, the Privy Council and the House of Lords as follows:

Payne v Deputy Federal Commissioner of Taxation [1936] AC 497
Pattison v Marine Midland Limited 57 TC 219

In her submission, the representative for the Commissioner also referred us to Payne v Deputy Federal Commissioner of Taxation.

It is surprising that the point at issue between the parties in this appeal has apparently never come before the courts, either in Hong Kong or elsewhere. Both of the two representatives informed the Board that they had not been able to find any authorities apart from the two cited to us. We would have thought that a point so fundamental and obvious as the question before us must have arisen on countless occasions in the past, but apparently that is not the situation. It may be that the facts of this case are unusual because the Taxpayer has ongoing carry forward losses for tax purposes for so many years.

There is no provision in our Inland Revenue Ordinance for disputing and deciding the quantum of carry forward tax losses. Not unnaturally our Inland Revenue Ordinance is geared to the collection of taxes which are assessed on profits. The provisions of sections 64 and 66 of the Inland Revenue Ordinance relating to objections to assessments and appeals to this Board of Review relate only to assessments. If an assessable profit is not made, a loss is computed but cannot be finally determined between the Commissioner and the Taxpayer until there is an assessable profit which, after allowing for past tax losses, can form the basis of the issuance of a tax assessment. It is only when an assessment has been issued that objection can be lodged under section 64 and appeal made under section 66. Accordingly it was not until the assessment for 1988/89 was issued that the Taxpayer could object and appeal to this Board.

As the Board said to the representatives appearing before it, the two cases cited are of limited value. The case of Payne v Deputy Federal Commissioner of Taxation has no real value to us. That was an unusual case of little merit. The taxpayer in that case resided in Australia and earned interest on stock in England. The interest was credited to his bank account in London. Being resident in Australia, the interest was subject to Australian tax. At that time in 1936, the Australian currency was denominated in pounds and pence in the same way as the currency of the United Kingdom. The tax law of Australia imposed a sliding rate of tax calculated in pence per pound. The assessor converted the interest which had been received by the taxpayer in London into Australian currency and then applied the Australian pence per pound calculation to the Australian currency amount. The taxpayer rather ingeniously but with no apparent substance argued that the amount to be taxed should be the amount stated in United Kingdom pounds and not Australian currency which at current exchange rates would have effected a substantial saving for the taxpayer. It is not surprising that the Privy Council rejected this argument and said that for Australian taxation purposes overseas income must be converted into Australian currency before it can be assessed. Though the Commissioner places great weight on this decision of the Privy Council, we find that it has no relevance to the matter to be decided before us. Our tax rates in Hong Kong are a percentage of the amount and no one is claiming in the case before us

that the rate of tax to be applied should be 16.5 Hong Kong cents for each one base currency unit. This is not what the Taxpayer is arguing.

The case cited by the representative for the Taxpayer, Pattison v Marine Midland Limited, also has limited value in the case before us. In that case, an American bank established a subsidiary in the United Kingdom which carried on the trade of international commercial banking. In accordance with good banking practice, the subsidiary matched its foreign currency obligations with foreign currency assets. The subsidiary borrowed from its parent a substantial sum of US dollars which it used to make loans in US dollars to its customers without converting the same into sterling. The subsidiary regarded the loan from its parent as a US dollar liability which it matched with US dollar assets. The subsidiary repaid the loan to its parent making use of US dollars which the subsidiary had. During the period from the inception of the loan up to the date of repayment, the value of the US dollar loan against sterling appreciated substantially and the Commissioner in the United Kingdom sought to tax the book gain and disregard the equivalent book loss. The taxpayer argued that it had made no gain because it had at all times carried the loan in US dollars and had paid the loan in US dollars and had matched its books so that there had been no currency exposure. The House of Lords decided the case in favour of the taxpayer. In the same way as it is difficult to understand Mr Payne's argument in the previous case, it is difficult to understand the Revenue's argument in the Pattison case. May be it was an attempt to extend the concept of Sharkey v Wernher [1956] AC 58. The House of Lords quite clearly stated that the taxpayer had not made any profit or loss and accordingly, there was no profit to be assessed. The Marine Midland case was a forlorn attempt by the Commissioner in the United Kingdom to use creative accounting so that a capital loss and a trading gain would be created with the taxpayer unable to offset the capital loss against the trading gain. Quite rightly the House of Lords would have nothing to do with such a proposition and confirmed the decision of the Court of Appeal and rejected the Commissioner's submission.

As we have said the Marine Midland case gives little guidance to us in the present circumstances other then to confirm the principle that only real profits should be taxed.

In approaching the case before us, we have first of all come to the conclusion that there is no distinction to be drawn in the computation and carrying forward of losses for a freighter which is assessed to tax under section 23C of the Inland Revenue Ordinance and any other person subject to profits tax. The rules are the same in both cases. We also point out that there is no obligation upon any taxpayer to maintain its books in Hong Kong dollars. A company or business in Hong Kong can maintain its accounts in whatever currency is most convenient for it.

The next fundamental point is that the object of the Inland Revenue Ordinance is to tax profits. The intention is that where a person carries on business in Hong Kong and makes a profit in Hong Kong, he should pay part of that profit by way of profits tax to the Hong Kong government for general revenue purposes. Section 23C of the Inland Revenue

Ordinance creates a notional or artificial method of calculating the profits of a person who carries on in Hong Kong a freighter business but this does not change the fundamental principle. All that section 23C of the Inland Revenue Ordinance attempts to do is to set down a method of calculation which will approximate the profit which the person actually earns in Hong Kong. It does nothing more and nothing less.

In trying to answer the question before us, we have looked further afield than the facts of the case before us and asked ourselves the question of what would be the situation if a company carried on business nowhere other than Hong Kong and made all of its profits or losses in Hong Kong and such company for good business reasons maintained its accounts in a foreign currency, for example US dollars. As we see it there is nothing wrong in such a proposition. A company which is trading with America with US dollar expenses and liabilities and which makes its profits and losses in US dollars, can and probably should maintain its accounts in US dollars truly to reflect its profit and loss each year. Taking the same hypothetical company, we have then looked at what would be the situation if such a company made losses over a number of years. As stated the spirit and intent of the Inland Revenue Ordinance is to tax profits made in Hong Kong. The Inland Revenue Ordinance allows losses in one year to be carried forward and offset against profits in subsequent years. It appears to us to be sensible and proper that a company such as we have mentioned can carry forward any losses which it has in the currency of its books of account. It appears to us to introduce artificiality into the matter if the company is required for Hong Kong taxation purposes to maintain a second set of accounts for tax purposes only and maintain these accounts in Hong Kong dollars. If this is done, then the company would be carrying on a separate 'trading account' between itself and the Inland Revenue Department under which it could make notional exchange profits or losses for taxation purposes depending upon fluctuations between US dollars and Hong Kong dollars. The company would have no means of hedging against such potential losses and might find itself ultimately paying tax upon notional currency gains which never exist. That is the situation in the case now before us. The Taxpayer in the case before us has been making notional currency profits by having its carry forward losses denominated in Hong Kong dollars as opposed to the base currency. In such circumstances it would appear to us to be wholly wrong that a company carrying on business in Hong Kong and nowhere else should find its tax liability changing depending upon exchange fluctuations which have nothing to do with its actual business.

As we have said we can see no reason for a distinction to be drawn between a company taxed under section 23C of the Inland Revenue Ordinance and any other company. This being the case we apply the same rules to the case before us as we would to the notional case which we have set out above and it is then clear that the Taxpayer is right in the way in which it has presented its accounts for taxation purposes. We take due note of the fact that in the case before us we are not dealing with a company carrying on business in Hong Kong alone, but with a branch of a company which has a worldwide business. We also take note of the fact that the branch is taxed on a proportion of worldwide profits and that because of the provisions of section 23C of the Inland Revenue Ordinance the affairs of the branch in Hong Kong for taxation purposes may be significantly different on an ongoing basis to those

of the company as a whole. This however is something over which we have no control and in its present form the Inland Revenue Ordinance does not draw any distinctions. If the Commissioner is so minded, he can propose to the Financial Secretary that an amendment be made to the law to specify that losses must be converted into Hong Kong dollars and then carried forward in Hong Kong dollars or that section 23C losses should be treated differently from other losses. However, to our mind, this would be both artificial and inappropriate. In the present case, the rate of exchange has worked in favour of the Taxpayer and against the Commissioner. However, where the base currency is depreciating in Hong Kong dollar terms, the converse would be the case.

As we said above, the submission made by the representative for the Commissioner has some logic and attraction to it. In effect, it means that each year the Commissioner would issue a tax loss certificate in Hong Kong dollars which can be used to offset against future tax assessments when they are raised in Hong Kong dollars. However, though it has some superficial attraction, we do not consider that is the law as set out in the Inland Revenue Ordinance. The concept of the Inland Revenue Ordinance is to allow a company to carry forward its losses for taxation purposes and this means in whatever currency which it uses for its accounts.

As mentioned above we appreciate that in the case of a freighter business and a branch of a company with a worldwide business there may be some aberrations but we can see no reason for drawing a distinction between a company taxable under section 23C and any other company assessable to tax in Hong Kong. Section 23C establishes a notional method of arbitrarily deciding how much of the worldwide profits is attributable to the business carry on in Hong Kong. Section 23 does no more. It does not change the principles or structure of the Inland Revenue Ordinance. The intention of the Inland Revenue Ordinance is to tax profits and where a company makes a loss in one year it is the intention of the Ordinance to allow that loss to be carried forward and offset against a future profit. When the concept of the Inland Revenue Ordinance is stated in these simple terms it is quite clear that the loss is to be carried forward in whatever currency the company uses for its accounts. The Inland Revenue Ordinance neither makes provision for nor requires losses to be converted into Hong Kong dollars for the purpose of being carried forward. The fact that a company's profits (and losses) are computed according to section 23C of the Inland Revenue Ordinance does not affect how losses are to be carried forward.

For the reasons given we allow this appeal and direct that the appeal be remitted back to the Commissioner to make appropriate amendments to the carry forward losses of the Taxpayer starting with the year of assessment 1972/73 in accordance with the table set out in fact 10 above.