Case No. D5/96

Profits tax – garment manufacturing and trading company – exchange losses – whether deductible or not.

Panel: William Turnbull (chairman), Nigel A Rigg and William Zao Sing Tsun.

Date of hearing: 11 December 1995.
Date of decision: 2 May 1996.

The taxpayer was a Hong Kong company carrying on a business of garment manufacturing and trading. The taxpayer's accounts for the years of assessment 1988/89 and 1989/90 showed that there were substantial exchange losses. The taxpayer paid the profits tax. Subsequently, the assessor noticed the above exchange losses and considered that the exchange losses were capital in nature and thus they were not deductible. The assessor raised additional profits tax on the taxpayer. The taxpayer appealed.

Held:

Evidence clearly showed that what the taxpayer did, regarding the exchange losses, were business transactions and all these transactions were made in Hong Kong. The exchange losses in question were deductible and so the additional assessments were annulled.

Appeal allowed.

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

Cases referred to:

D19/88, IRBRD, vol 3, 255
D61/88, IRBRD, vol 4, 62
D62/88, IRBRD, vol 4, 62
D50/91, IRBRD, vol 6, 283
Lewis Emanuel & Sons Ltd v White [1965] 42 TC 369
D42/90, IRBRD, vol 5, 316
Cayzar Irvine & Co Ltd v CIR [1942] 24 TC 491
Salt v Chamberlain STC 750
Cooper v C & J Clark Ltd [1982] STC 335
Marson v Morton [1986] STC 463

CIR v Reinhold [1953] SC 49
Wisdom v Chamberlain [1968] 2 ALL ER 714
CIR v Livingston [1926] SC 251
Californian Copper Syndicate v Harris [1904] 6F (Ct of Sess) 894
D20/90, IRBRD, vol 5, 164
D57/94, IRBRD, vol 9, 335
Cooper v Stubbs [1925] KB 753
Lewis Emanuel & Sons Ltd v Southall 42 TC 371
Ransom v Higgs [1974] 1 WLR 1594

Chiu Kwok Kit for the Commissioner of Inland Revenue.
Reynold Hung of Messrs Price Waterhouse for the taxpayer.

Decision:

This is an appeal by a private limited company against two profits tax assessments for the years of assessment 1988/89 and 1989/90. The company claims that certain exchange losses should be allowed as deductions against its assessable profits. The facts are as follows:

1. The Taxpayer was incorporated as a private company in Hong Kong on 23 November 1957.

2. Since incorporation, the Taxpayer has been carrying on a business of garment manufacturing and trading.

3. In 1970, the Taxpayer acquired a piece of land in Place A and redeveloped it into a 12-storeys factory building. The building was used partly for its garment business and partly for generating rental income.

4. From 1979, the Taxpayer carried on its garment business in Country B as well as in Hong Kong. The profits from the Country B operation were accepted by the assessor as offshore profits.

5. In July 1988, the Taxpayer's garment business in Country B ceased, but its garment business in Hong Kong continued.

6. The Taxpayer's accounts for the years ended 31 March 1987 and 1988 showed inter alia the following particulars:

   (a) <u>Retained earnings</u>

as at 31-3-1987	$144,567,723
as at 31-3-1988	$182,504,209

(b) Gross profits from garment sales

year ended 31-3-1987	$45,696,040
year ended 31-3-1988	$39,015,541

(c) Rental income

year ended 31-3-1987	$8,589,267
year ended 31-3-1988	$8,729,400

(d) Short term deposits

as at 31-3-1987	$68,810,123
as at 31-3-1988	$116,970,599

(e) Interest income

year ended 31-3-1987	$598,651
year ended 31-3-1988	$828,863

(f) No dividend was declared or paid for these two years.

7. On 29 November 1989, the Taxpayer submitted its profits tax return for the year of assessment 1988/89, accounts for the year ended 31 March 1989 and tax computation. The accounts showed, inter alia, the following particulars:

(a) Retained earning

as at 31-3-1989	$42,455,361

(b) Gross profits from garment sales

year ended 31-3-1989	$11,802,045

(c) Rental income

year ended 31-3-1989	$9,411,372

(d) Short term deposits

as at 31-3-1989	$143,073,761

(e) Interest income

year ended 31-3-1989	$9,224,960

(f) Dividends

Interim dividends of HK$234 and HK$350 per ordinary share, totalling HK$175,200,000 were declared on 31 December 1988 and 30 March 1989 respectively. The dividends were not paid in cash on the respective dates, but were credited to the accounts with the shareholders.

(g) Exchange loss $3,574,145

8. On 16 February 1990, the assessor raised a profits tax assessment for the year of assessment 1988/89 on the Taxpayer in accordance with its tax computation. The Taxpayer did not object against this assessment.

9. On 29 November 1990, the Taxpayer submitted its profits tax return for the year of assessment 1989/90, accounts for the year ended 31 March 1990 and tax computation. The accounts showed, inter alia, the following particulars:

(a) Retained earning

as at 31-3-1990 $25,210,993

(b) Gross profits from garment sales

year ended 31-3-1990 $2,393,115

(c) Rental income

year ended 31-3-1990 $16,224,000

(d) Short term deposits

as at 31-3-1990 $33,764,144

(e) Interest income

year ended 31-3-1990 $4,946,641

(f) Dividends

Interim dividend of $111 per ordinary share, totalling HK$33,300,000 was declared on 30 March 1990. The dividend was not paid in cash on that date, but was credited to the accounts with the shareholders.

(g) Exchange loss $4,052,961

10. On 24 December 1990, the assessor raised a profits tax assessment for the year of assessment 1989/90 on the Taxpayer in accordance with its tax computation. The Taxpayer did not object against this assessment.

11. The assessor questioned the nature of the exchange loss at fact (7)(g) and fact (9)(g). From the information provided by the Taxpayer's representatives, (the Representatives), the assessor found that:

(a) The interest income for the year of assessment 1988/89 should be as follows:

Interest from deposits placed:	**HK$**
- outside Hong Kong - CAD deposit	1,269
USD deposit	8,345,729
- in Hong Kong	552,667
Interest from Japanese Yen deposits outside Hong Kong	325,295
Total [see fact 7(e)]	9,224,960

The offshore deposits were placed with Bank C in Country D.

(b) The interest income for the year of assessment 1989/90 should be as follows:

Income from offshore deposits:	**HK$**
- USD call deposits	1,389,885
- CAD deposits	1,988,032
- Canadian Treasury Bill	746,937
- Japanese Yen call deposit	674,940
Income from local deposits:	
- USD call deposits	131,728
- HKD call deposits	5,890

- CAD call deposits	9,229
Total [see fact 9(e)]	4,946,641

(c) The exchange losses were as follows:

	1988/89 HK$	**1989/90 HK$**
Arising from:		
- Japanese Yen	3,560,802	4,050,768
- Garment trading transactions	13,343	2,193
	3,574,145	4,052,961
	[fact (7)(g)]	[fact (9)(g)]

(d) The Taxpayer had a US Dollar call deposit account, with Bank C in Hong Kong (the Hong Kong Account). The Taxpayer also had a deposit account, with Bank C in Country D (the Country D Account).

(e) The interest of $8,345,729 at (a) above was derived from deposits in the Country D Account as follows:

Period	**Principal US$**	**Term**	**Interest US$**
18-4-88 to 3-6-88	2,000,000	Overnight	17,517
3-6-88 to 15-7-88	3,017,517	Overnight	25,653
28-3-88 to 1-9-88	12,000,000	One month	386,056
1-9-88 to 5-1-89	16,386,056	One month	488,148
5-1-89 to 31-3-89	16,874,204	Call	152,591
	(reduced from time to time)		1,069,965
		Equivalent to	HK$8,345,729

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(f) In January and March 1989, the Taxpayer made 13 deposits of Japanese Yen into the Country D Account as follows:

Date	Deposits (Yen)	Costs (US$)	HK$ equivalent	Exchange Rate
4-1-89	62,875,000	500,000	3,900,000	0.06202783
10-1-89	251,700,000	2,000,000	15,600,000	0.06197854
11-1-89	252,200,000	2,000,000	15,600,000	0.06185567
11-1-89	378,000,000	3,000,000	23,400,000	0.06190476
13-1-89	63,400,000	500,000	3,900,000	0.06151419
18-1-89	63,375,000	500,000	3,900,000	0.06153846
18-1-89	126,650,000	1,000,000	7,800,000	0.06158705
23-1-89	38,550,000	300,000	2,340,000	0.06070038
16-3-89	26,000,000	200,000	1,560,000	0.06000000
16-3-89	39,000,000	300,000	2,340,000	0.06000000
22-3-89	65,500,000	500,000	3,900,000	0.05954198
23-3-89	132,000,000	1,000,000	7,800,000	0.05909090
31-3-89	133,200,000	1,000,000	7,788,000	0.05846846
	1,632,450,000	12,800,000	99,828,000	

(g) The Japanese Yen was purchased in Hong Kong from Bank C in Hong Kong. The Japanese Yen purchased was deposited into the Country D Account as call deposits.

(h) For the first purchase of Japanese Yen, the US dollar came from the Hong Kong Account. For the subsequent purchase, the US dollar all came from the Country D Account, that is, by reducing the US dollar call deposits [see (e) above] from time to time.

(i) The exchange loss of $3,560,802 for the year of assessment 1988/89 [see (c) above] was calculated as follows:

Yen deposits as at 31-3-89 [see (f) above]	1,632,450,000
Interest earned up to 31-3-89	5,747,270
Balance as at 31-3-89	1,638,197,270
Year-end conversion to HK dollar at 0.05897	96,604,493
Cost of deposits in HK dollar [see (f) above]	99,828,000
Add: Interest in HK dollar	337,295
	100,165,295

Exchange loss = $100,165,295 - $96,604,493
= $3,560,802

(j) The breakdown of the short term deposits as at 31-3-1989 [see fact 7(d) above] was as follows:

With Bank C, Country D	HK$
Yen 1,638,197,270	96,604,493
US$ 4,726,795	36,869,007
With Bank C, Hong Kong	
US$292,458	2,281,173
HK$7,319,088	7,319,088
	143,073,761

(k) On 23 May 1989, the Taxpayer withdrew part of its Japanese Yen deposits in the Country D Account as follows:

Deposits Withdrawn	Converted into	HK$ equivalent	Exchange Rate
JPY138,700,000	US$1,000,000	7,800,000	0.05623648
JPY138,900,000	US$1,000,000	7,800,000	0.05615550
JPY138,800,000	US$1,000,000	7,800,000	0.05619596
JPY416,400,000	US$3,000,000	23,400,000	

The Japanese Yen was sold to Bank C in Hong Kong for US Dollars. The sales proceeds (in US Dollars) were deposited into the Country D Account.

(l) On 4 August 1989, the Taxpayer uplifted the balance of the Japanese Yen deposits (JPY1,221,797,270) together with the accrued interest up to 4 August 1989 (JPY11,924,734) from the Country D Account and remitted the same (without conversion into any other currency) to its shareholders' account in Country E to reduce the amounts due to them by the Taxpayer.

(m) The exchange loss of $4,050,768 for the year of assessment 1989/90 [see (c) above] was calculated as follows:

Date	Particulars	JPY	HK$ equivalent	Exchange Rate
1-4-89	balance b/f [see (i)]	1,638,197,270	96,604,493	0.0589
23-5-89	withdrawal [see (k)]	(416,400,000)	(23,400,000)	0.0562
4-8-89	interest	11,924,734	674,940	0.0566
	withdrawal [see (1)]	(1,233,722,004)	(69,828,665)	0.0566
	Exchange loss		4,050,768	

(n) There were no board of directors minutes documenting the intention of the placement and withdrawal of the Japanese Yen deposits.

(o) The interest rates applicable to Japanese Yen call deposits were lower than those applicable to US Dollar call deposits during the period from 4 January 1989 to 4 August 1989 by a range of about 4% to 6%.

12. The Taxpayer accounts for the years of assessment 1990/91 to 1992/93 showed the following short term deposits:

As at	**Short term deposit**
31-3-1991	$44,871,292
31-3-1992	$ 4,514,138
31-3-1993	$46,771,241

13. According to the recommended rates published by the Exchange Banks Association, the exchange rates for Japanese Yen in 1988 were as follows:-

Month	**Mean of Average Buying & Selling Rates for Month**
January	0.061050
February	0.060320
March	0.061256
April	0.062414
May	0.062563
June	0.061284
July	0.058613
August	0.058401
September	0.058031
October	0.060412
November	0.063347
December	0.063158

14. The assessor considered that the Taxpayer's exchange loss for the years of assessment 1988/89 and 1989/90 was capital in nature. On 25 June 1991, the assessor raised the following additional profits tax assessments on the Taxpayer:

Year of Assessment 1988/89 (Additional)

Exchange loss [fact 11(c)]	$3,560,802
Less: Interest from JPY deposits	359,776
Additional Assessable Profits	$3,201,026
Additional Tax Payable	$ 544,174

Year of Assessment 1989/90 (Additional)

Exchange loss [fact 11(c)]	$4,050,768
Less: Interest from JPY deposits	674,940
Additional Assessable Profits	$3,375,828
Additional Tax Payable	$ 557,011

15. By letter dated 25 July 1991, the Representatives objected against the additional assessments on the following grounds:

'1. The profits assessed are excessive.

2. The exchange losses of HK$3,560,802 and HK$4,050,768 arising on the Japanese Yen deposit for the years of assessment 1988/89 and 1989/90 respectively should be deductible under section 16(1) of the Inland Revenue Ordinance (the IRO). Our client converted US dollar funds into Yen with the intention of deriving a speculative gain on the exchange rate movements of the Japanese currency. The deposit was made merely to derive some interest income while awaiting for the opportune time to convert the funds back to US dollars to make a trading gain. Hence, the deposit made was a call deposit so that funds could be retrieved and exchanged into another currency at any time.

The funds were converted from US dollars into Japanese Yen in Hong Kong and then deposited with Bank C, Country D branch. Upon uplift of the deposit, some of the funds (Yen 416,400,000) were converted back into US dollars in Hong Kong and the balance (Yen 1,233,722,004) was transferred to Country E as dividend payment to the shareholders. The transfer was made in Yen currency upon the instruction by our client to Bank C, Hong Kong Branch. The dividend was declared in Hong Kong dollars and the then prevailing market exchange rate was used to calculate the Yen equivalent of the dividend payment. From the foregoing, it is clear that there was realisation of the exchange loss when the Yen funds were converted back into US dollars or applied to settle a liability of the Taxpayer.

As mentioned above and can clearly be seen from the frequency of the transactions in question, our client's intention in acquiring Yen was to derive speculative gains arising from appreciation in the Yen currency. Therefore, any resultant gain/loss from such speculative activities is revenue in nature.

Regarding the source of the speculation gain/losses, with the foreign exchange contracts on purchase of Yen and sale of Yen being made in Hong Kong, the decision to apply the Yen funds to pay dividends being taken in Hong Kong and the crucial instruction to the bank being given in Hong Kong, there can be no doubt, on the application of the guidelines set out in the recent Privy Council decision in the Hang Seng Bank case, that the exchange losses were sourced in Hong Kong.

On the basis that the exchange losses resulted from the Taxpayer's currency trading activities carried on in Hong Kong and were realised and revenue in nature, we submit that the exchange losses are deductible under section 16 of the IRO.

3. The assessments are otherwise incorrect.'

16. The assessor has since accepted the Representatives' argument regarding the source or locality of the exchange losses in question.

17. By his determination dated 4 April 1995 the Commissioner confirmed the two additional assessments to profits tax dated 25 June 1991.

18. By notice dated 3 May 1995, the Taxpayer appealed to the Board of Review against the determination of the Commissioner.

At the hearing of the appeal the Taxpayer was represented by its tax representative and a director and the financial controller of the Taxpayer were called to give evidence and be cross examined. The representative for the Taxpayer submitted that the

issue before the Board was largely a matter of fact. He referred us to the facts contained in the Commissioner's determination and which are the facts which we have set out above. Although he agreed that the facts were correct he submitted that they were biased in favour of the Commissioner. He pointed out that it was true that the Taxpayer had been carrying on a business of garment manufacturing and trading but its activities went beyond this. As the two witnesses gave evidence which we accept and which we set out below it is not necessary for us to deal further with the arguments made on behalf of the Taxpayer with regard to the Commissioner's fact. There is nothing wrong with the Commissioner's facts other than (i) to the extent of emphasis and (ii) that the evidence from the witnesses is not contained therein so that the Commissioner's facts are not complete. It is therefore appropriate for us to summarise the evidence given by the two witnesses and which we accept as being true and correct.

The first witness was a director of the Taxpayer, having been educated in Country E with a bachelor degree.

She said that the Taxpayer had been founded by her father and that its principle business had been garment manufacturing and trading. In later years the Taxpayer also engaged in the business of property investment. She said that at all times the Company had been controlled by her family which owned 99.9% thereof.

She said that she was the family member who was in charge of the day to day management of the Taxpayer and who made most of the business decisions.

She said that the garment business of the Taxpayer had been carried on in Hong Kong and Country B. The business in Hong Kong was mainly transacted in HK Dollars. Surplus funds were lent to family members in HK Dollars. The business in Country B was transacted in US Dollars and funds received were put into the US Dollars account of the Taxpayer in Hong Kong. Surplus US Dollars were held by the Taxpayer and placed on deposit.

Years of profitable business in Country B had enabled the Taxpayer to build up a significant amount of US Dollars.

In early 1988 it was contemplated that the Taxpayer should cease its business in Country B. While the business in Country B was phasing out more and more US Dollars became surplus to the requirements of the Taxpayer. In March 1988 the Taxpayer started to uplift US Dollars deposits from its Hong Kong account and put the same on deposit with the same bank in Country D.

On 5 January 1989 the Taxpayer converted one term deposit in the Country D account of approximately US$12,000,000 into a call deposit. The conversion was intended to provide the working capital required for the Taxpayer's dealing in Japanese Yen.

The witness then explained the dealing by the Taxpayer in Japanese Yen. She said that she was the person making decisions for the Taxpayer to purchase Japanese Yen

during the period December 1988 to March 1989. Her decision to deal in Japanese Yen was influenced by a number of events namely:

1. The closure of the business in Country B in July 1988 resulted in substantial surplus funds being available in US Dollars which the witness was keen to put to good use.

2. She had been a regular reader of the Asian Wall Street Journal and towards the end of 1988 she saw various reports forecasting that Japanese Yen would appreciate significantly in value in the short term as compared with US Dollars. Various reports forecasted that the dollar/Yen exchange rate would reach the level of Yen 110 to USD1.00.

3. The reports which she read in the Asian Wall Street Journal were also consistent with what she had heard from friends in the garment industry. She and her friends were conversant with Japanese Yen because many business transactions in the garment business involved purchasing fibre from Japan in Japanese Yen. The discussion at that time suggested that Japanese Yen would appreciate in the short term relative to US Dollars.

4. Her eldest brother in Country E was also supportive of the view that Japanese Yen would appreciate in the short term.

5. She asked the financial controller of the Taxpayer to talk to the Taxpayer's bank and the bank also recommended the purchase of Japanese Yen.

6. In view of the bullish and consistent view expressed by everyone the Taxpayer made its first purchase of Japanese Yen on 30 December 1988. Instruction was given by the witness to the financial controller. The Taxpayer purchased an amount of Japanese Yen equivalent to US$500,000. This purchase of Yen was settled from a US Dollars deposit of the Taxpayer held in Hong Kong.

7. When the one month term deposits of US Dollars in Country D matured on 5 January 1989 the Taxpayer converted the deposits into a call deposit to provide the working capital for Japanese Yen dealings.

8. From 6 January 1989 to 29 March 1989 the Taxpayer made 12 further purchases of Japanese Yen.

9. The strategy used by the Taxpayer was to try to buy Yen at a low price and sell it at a high price. After the first purchase of Japanese Yen the Yen appreciated in value and it could have been sold for a profit. However the witness decided not to sell because she was of the view that the profit would be marginal and was far from the 110 level which had been mentioned earlier. On 11 January 1989 the financial controller sought her instructions as to whether or not to sell

the Yen and take a profit. She decided not to do so as she thought that the exchange rate would move further in favour of the Taxpayer.

10. After 11 January 1989 the Yen exchange rates deteriorated. As the rate deteriorated subsequent purchase of Japanese Yen were made to average down the cost.

11. By the end of March 1989 the overall position was getting out of control. At that time the witness realised that the Taxpayer had suffered a loss of over HK$3,500,000 on its Japanese Yen and it was unlikely that the exchange rate would go to anywhere near the 110 level. Reports from newspapers and discussions with friends all suggested a less bullish view for the Japanese Yen. The witness also understood from the financial controller that the bank were 'equivocal' with regard to Japanese Yen. The business instincts of the witness told her to stop purchasing Japanese Yen and seek a way out for the Taxpayer.

12. The Japanese Yen exchange rate continued to deteriorate and on 19 May 1989 the witness decided to limit the exposure of the Taxpayer. The Taxpayer made three separate sales for US$1,000,000 each during the day. After 19 May 1989 the Japanese Yen further deteriorated and reached an ebb in mid June 1989. There was then a reverse of trend and in early August the Japanese Yen recovered part of its loss. Urged by her father the witness said that she caused the Taxpayer to distribute the remaining Japanese Yen amongst its shareholders to satisfy a dividend which the Taxpayer had declared. The Japanese Yen was remitted to an account controlled by the shareholder in Country E. Although it does not strictly concern the Taxpayer the witness said that her family thought that her brother in Country E would be better able to handle the Japanese Yen for the benefit of the family and that subsequently her brother sold the Japanese Yen and converted it into US Dollars within days of the money being transferred to his control in Country E. She said that with the benefit of hindsight the decision of her brother had been sound because the Japanese Yen again deteriorated later in August and the deterioration was not reversed until early 1990.

13. The witness said that throughout the period that the Taxpayer held Japanese Yen she instructed the financial controller to continuously monitor the Yen exchange rates.

The second witness was the financial controller who confirmed the evidence given by the director and it is not necessary for us to set out his evidence in detail. He said that the currency transactions were conducted by him on behalf of the Taxpayer in Hong Kong dealing with the Taxpayer's bankers in Hong Kong. Settlement was made by means of using US Dollars held by the company in Hong Kong or in Country D.

The representative for the Commissioner, inter alia cross examined the director with regard to why details of the Yen trading had not been included in the turnover figures

of the Taxpayer in its audited accounts. She referred this question and other similar accounting questions to the financial controller. She was also questioned with regard to the Taxpayer keeping money with the bank in Country D.

The financial controller was likewise questioned with regard to the reason for keeping money in Country D and he referred to changes which were made to tax law in Hong Kong which made interest on money held in Country D exempt from Hong Kong tax. He confirmed that the Taxpayer had not paid tax on interest earned outside of Hong Kong. With regard to the interest on the Japanese Yen deposits the witness said that at first tax was paid in Hong Kong on the interest but later it was not. He was further cross examined on this point and said that the difference between offshore deposits in US Dollars not being taxable and interest on Yen being taxable was because the Japanese Yen was used for trading. He was also cross examined with regard to the Yen transactions not being included in the turnover figures and sales figures of the Taxpayer. He explained that this was the practice used by the Taxpayer in keeping its accounts. He said that only garment trading business was included in the sales figures for the Taxpayer. The witness confirmed to the Board that all of the Yen dealing transactions had been effected by him in Hong Kong with the bankers of the Taxpayer in Hong Kong.

The representative for the Taxpayer submitted that the exchange losses were trading losses allowable to be deducted from the Taxpayer's assessable profits. The Taxpayer claimed that the exchange losses were trading in nature and should allow to be deducted from the assessable profit of the company. The representative referred us to the fact and drew our attention to certain differences of view or opinion between the Taxpayer and the Commissioner with regard to the same. We were referred in some detail to the evidence given by the director of the Taxpayer. The representative submitted that the transactions in Japanese Yen were traded transactions and referred us to D19/88, IRBRD, vol 3, 255. We were then referred to two further decisions D61/88 and D62/88, IRBRD, vol 4, 62. It was submitted that the intention of the Taxpayer was the person who controlled it and that was the director who gave evidence. We were then referred to case D50/91, IRBRD, vol 6, 283, Lewis Emanuel & Sons Ltd v White 42 TC 369, D42/90, IRBRD, vol 5, 316 and Cayzar Irvine & Co Ltd v CIR 24 TC 491. We were then taken to the 'badges of trade' but as the facts before us are quite clear it is not necessary for us to refer at any length to this part of the submission made on behalf of the Taxpayer.

The representative for the Commissioner submitted that it was a straight forward case. He submitted that all that the Taxpayer had done in relation to the alleged Yen currency dealing transactions were, (i) to enter into thirteen foreign exchange contract to exchange US Dollars for Yen, (ii) to retain the Yen in its existing Country D bank account (iii) to enter into three foreign exchange contracts to exchange Yen for US Dollars, and (iv) to transfer the balance of the Yen to a Country E account. He submitted that these actions on their own could not constitute a trade or business of currency dealing. He referred us to the facts in some detail. He said, inter alia, that the Taxpayer had not represented itself as a currency dealer, had no documentary evidence to show that it had decided to commence or cease currency dealing trade or business, had not argued that it had

traded in any other currency and that the Taxpayer was not a bank or deposit taking company and money was not its stock in trade.

The representative for the Commissioner drew our attention to what he called 'the accounting evidence' and drew our attention at some length to the manner in which the Taxpayer maintained its audited accounts.

He said that to succeed the Taxpayer must prove that it was carrying on a trade or business which involved dealing in Yen currency and that the currency dealing trade or business was located in Hong Kong. He said that the Taxpayer must prove that the losses described as 'exchange losses' arose in or derived from Hong Kong and thirdly the Taxpayer must prove that the losses were from its currency trade or business which was carrying on in Hong Kong. With due respect it would appear to us that these three requirements are a little tautologous. Once again the facts are quite clear and it is not necessary for us to further analyze this part of the Commissioner's submission.

The representative for the Commissioner then made a detailed submission of law with regard to carry on a currency trade or business. He referred us to the following authorities:

1. Salt v Chamberlain STC 750
2. Cooper v C & J Clark Ltd [1982] STC 335
3. Marson v Morton [1986] STC 463
4. CIR v Reinhold [1953] SC 49
5. Wisdom v Chamberlain [1968] 2 ALL ER 714
6. CIR v Livingston [1926] SC 251
7. Californian Copper Syndicate v Harris [1904] 6F (Ct of Sess) 894
8. D20/90, IRBRD, vol 5, 164
9. D42/90, IRBRD, vol 5, 316
10. D57/94, IRBRD, vol 9, 335
11. Cooper v Stubbs [1925] KB 753
12. Lewis Emanuel & Sons Ltd v Southall 42 TC 371
13. Ransom v Higgs [1974] 1 WLR 1594

Having submitted that speculative dealings raised a prima facie presumption that the person is not carrying on a trade or business, the representative submitted that the question to be decided was one of facts and that all facts should be considered and not only some of them.

He submitted that a purchase plus an intention to sell is not sufficient to become an adventure in the nature of trade if the subject matter is not normally purchased for investment and the person's business is not to trade in that kind of subject matter. He said that an investment is always expected to be realised at a profit when purchased but realisation of an investment is not trading. He then submitted that a security to protect against devaluation or depreciation in value is not an adventure in the nature of trade.

With due respect to the Commissioner no evidence was ever given before us that the Taxpayer was concerned with devaluation or depreciation of currency. What we were expressly told was that the purchase of Yen was because it was expected that the Yen would go up in value and a profit would be made. We were then told that the Taxpayer let all the characteristics of a currency dealer. We were further told that for a trade of foreign exchange dealing to exist one would normally expect to find some habitual or systematic operations. It was pointed out to us that the foreign exchange contracts were filled in numbers and were made within a short period. It was submitted that they were no more than isolated transactions.

The representative then went on to submit that even if the Taxpayer could succeed in proving that there was a currency trade or business it must prove that the currency trade or business was carried on in Hong Kong. Our attention was drawn to the fact that the US Dollars and the Yen were at all relevant times placed in Country D and that the bank account in question was maintained in Country D and not in Hong Kong. It was submitted that the depreciation had taken place over a period of time when the Yen was on deposit in Country D. The sales or transfer of the Yen were merely a realisation of the loss.

It was submitted that the losses did not arise in nor derive from Hong Kong. It was then submitted that the currency were capital assets and not trading assets. Our attention was drawn to the fact that the interest income from the US Dollars was not assessable to tax in Hong Kong because it was on deposit outside of Hong Kong.

We agree with an opening remark of the representative for the Taxpayer. The question which we must decide is largely a question of fact. The answer lies in the evidence given by the director and the financial controller.

It is clear from the evidence that the Taxpayer bought and sold Japanese Yen in Hong Kong. Of this there is no doubt. The financial controller was very clear that all dealing transactions were made by him in Hong Kong with the banker of the Taxpayer in Hong Kong. Accordingly whether the loss is deductible or not is not a question of where did the loss arise.

The argument for the revenue was that the Taxpayer was not a currency trading company. It was a garment manufacturing and trading company. The funds which it had available were part of that business and became surplus to the requirement of that business. We find this submission by the representative for the Commissioner to be a little strange. In approaching submissions of this nature we ask ourselves the question what would be the Commissioner's view if a substantial profit had been made. We have no hesitation in saying that such a profit would have been taxable in Hong Kong. The Taxpayer is a limited liability company established for the purpose of making profit for its shareholders. It had funds available to it which it did not require for carrying on its previous business. Indeed the evidence before us is to the effect that the previous business had closed. The garment business in Country B had been terminated. The Taxpayer then had a choice. It could distribute the surplus funds to its shareholders either in the form of dividends or, following past practice with Hong Kong Dollars, by way of loan to its shareholders. It chose not to do

so. Instead it chose to embark upon currency speculation or trading. After placing a tentative toe into the water it decided to go further. Having made an initial comparatively small Yen purchase further purchases were made. Unfortunately the Taxpayer was wrong in its assessment of the currency. As any trader might do, it decided to average down. It continued to buy Yen in the hope that the downward trend would be reversed and it could still achieve its intended profit. It was not successful. Eventually, as so often has happened in the past with currency traders the Taxpayer lost its nerve. It decided to cut its losses. It did so in a rather unusual way but we see nothing significant in this. Instead of selling the Yen in the open market it decided to declare a HK Dollar dividend, being the base currency of its accounts, and then use the Japanese Yen, in specie, to satisfy its Hong Kong Dollar obligation to its shareholders. This was done by transferring the Japanese Yen to an account managed by a member of the family in Country E. So far as we are concerned in this case the effect of that transaction was that the Taxpayer realised a book loss which it had suffered on Japanese Yen trading.

It is quite clear to us that what the Taxpayer did was a business transaction and that the Taxpayer is entitled to offset the loss in the same way as if it had been a profit it would have been assessable to profits tax. The representative for the Revenue sought to try and show that because of the treatment of the currency trading in the accounts of the Taxpayer it was not a trading transaction. We find no merit in this. What we must do is to look at the essence of the transactions on the clear evidence before us. How the Taxpayer reflected the transactions in its accounts cannot change the nature of the transactions. However the evidence given by the financial controller was in our opinion satisfactory. He said that this is how the Taxpayer had dealt with currency gains and losses in the past and they had continued the same treatment with regard to this trading in Japanese Yen.

The Commissioner was clearly aggrieved at the fact that the Taxpayer was able to hold US Dollars offshore and not pay tax on interest earned. With due respect to the Commissioner this is his affair and if he had wished to tax offshore interest then he should have so amended the Inland Revenue Ordinance at that time. The currency trading took place in Hong Kong. Because deposits maintained offshore were used to settle the obligation of the Taxpayer in Hong Kong is not material. Indeed if such considerations were material it would open the floodgates for tax planners in Hong Kong who would be able to transfer the profits of Hong Kong traders outside of Hong Kong by making settlement from offshore deposits.

For the reasons given we find in favour of the Taxpayer. Before the two additional assessments dated 25 June 1995, which are the subject matter of this appeal, were issued the Taxpayer had been assessed to profits tax on the basis that the exchange losses in question were deductible. The two additional assessments were issued to exclude these losses. Accordingly having found in favour of the Taxpayer it is only necessary for us to order that the two additional assessments against which the Taxpayer has appealed should be annulled.