

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D73/97

**Profits tax** – whether taxpayer entitled to deduct the ‘Foreign Exchange Loss’ in ascertaining profits – section 17(1) of the Inland Revenue Ordinance.

Panel: Andrew Halkyard (chairman), Aarif Tyebjee Barma and William E Mocatta.

Date of hearing: 9 October 1997.

Date of decision: 30 October 1997.

The taxpayer is a private company engaged mainly in the activity of investment holding and earning interest from bank deposits. The taxpayer sought to deduct from its assessable profits a sum of HK\$659,818 as ‘Foreign Exchange Loss’ in the profits tax return for the year of assessment 1991/92.

Held:

1. The suggestion that the foreign currency time deposit was taken out for an investment purpose was rejected. In these circumstances, the purchase of foreign currency for a speculative purpose, cannot simply be equated for all purposes with a typical bank account balance which has been described as quintessentially a capital asset.
2. The issue herein is not whether the foreign currency assumed the nature of capital when it was accumulated over time and place on deposit with the intention of obtaining more interest and more favourable exchange rates. Rather, the issue is whether, when the taxpayer purchased the foreign currency, did it do so with the intention of selling it at a profit. CIR v Li & Fung Ltd distinguished.
3. That is, bearing in mind the taxpayer’s burden of proof set out in section 68(4), whether the taxpayer as a matter of objective fact purchased foreign currency with the intention of reselling at a profit. If it did, then the loss would arise from an adventure in the nature of trade and should be taken into account in computing the taxpayer’s assessable profits. Simmons v IRC (1980) 53 TC 461 followed.
4. The transaction giving rise to the loss in dispute was entered into a short-term basis for the purpose of making a profit from the purchase and sale of foreign currency.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

5. Given all the facts herein, it is concluded that when the taxpayer purchased Deutsche marks, it was not investing in foreign currency; rather it was doing a deal.
6. If the taxpayer has made a gain rather than a loss from its foreign exchange transaction, the Commissioner would be entirely justified in assessing the gain to profits tax and should not be constrained by the fact that the gain arose from an isolated transaction and that the taxpayer has no systematic and habitual dealings in foreign exchange.

### **Appeal allowed.**

Cases referred to:

CIR v Li & Fung Ltd (1980) 1 HKTC 1193  
Simmons v CIR (1980) 53 TC 461

J R Smith for the Commissioner of Inland Revenue.  
Ronald H T Lee of Messrs Ronald H Lee & Co for the taxpayer.

### **Decision:**

The Company has appealed against the Commissioner's decision to disallow its objection to its additional profits tax assessment for the year of assessment 1991/92. The Company claims that a realised exchange loss arising from the conversion of a foreign currency time deposit should be deducted in the computation of its assessable profits.

### **The facts**

The following facts were not in dispute.

1. The Company was incorporated in Hong Kong as a private company on 6 March 1990. In the Report of the Directors for the period from 6 March 1990 to 31 March 1991, the main activity of the Company was described as investment holding and earning interest from bank deposits. In its profits tax return for the year of assessment 1991/92, the nature of the Company's business was declared as investment holding, provision of management services and purchasing services, and purchasing agent of textile raw materials.
2. The Company's 1991/92 profits tax return declared assessable profits of \$300,867. This sum was arrived at after deducting a foreign exchange loss of \$659,818.
3. The assessor assessed the Company on its declared profits of \$300,867 and, at the same time, made enquiries relating to the foreign exchange loss. The Company did not

## INLAND REVENUE BOARD OF REVIEW DECISIONS

object to the assessment which became final and conclusive in terms of section 70 of the Inland Revenue Ordinance ('the IRO').

4. In reply to the assessor's enquiries, the Company, through Messrs Ronald H T Lee & Co. ('the Representative'), stated:

'The loss arose from the realisation of foreign currency (DM) time deposit of DM 1,009,733.71 on the maturity date, 13 May 1991. The drop of exchange rate from DM1=HK\$5.112 on 10 January 1991 to DM1=HK\$4.46 on 13 May 1991 resulted in total realised exchange loss of HK\$659,818.28 computed as follows:

DM time deposit at Bank A or the period from 10 January 1991 to 13 May 1991.

Principal (DM)	Rate	HK\$
1,009,733.71 (commencement)	5.112	5,161,758.73
1,009,733.71 (maturity)	4.46	<u>4,503,412.35</u>
Loss on exchange for principal		658,346.38
<u>Add: Loss on exchange for interest</u>		<u>1,471.90</u>
Total exchange loss per accounts		<u><u>659,818.28'</u></u>

5. The assessor considered that the loss on exchange was capital in nature and raised an additional assessment on the Company showing additional profits of \$659,818.

6. The Representative, on behalf of the Company, objected to the additional profits tax assessment as follows:

'The realised exchange loss of \$659,818 in connection with (DM) time deposit is of a revenue nature and the loss was necessarily incurred in the ordinary course of the company's business activities which were investment holding, interest earning from bank deposits and speculation in foreign exchange.

Interest income from the time deposit had been included in the company's financial accounts as revenue income as follows.

Accounting Period	Bank interest
6 March 1990 to 31 March 1991	\$ 89,533

## INLAND REVENUE BOARD OF REVIEW DECISIONS

Year ended 31 March 1992

47,663

137,196

The time deposit was originally kept in Hong Kong currency. The swap into (DM) was made as part of the management's decision in the normal course of running the company's exchange speculation business.'

7. In support of the objection the Representative stated that a sum of \$5,000,000 was advanced by the Company's parent company, B Limited. This sum was placed in a fixed deposit with the Bank A on 13 August 1990. The principal and interest were rolled over on maturity of the deposit until 10 January 1991 when the principal and interest amounting to \$5,161,758 were converted, in anticipation of strong Deutsche marks against the Hong Kong dollar, in the form of a monthly time deposit with the same bank. The principal and interest were again rolled over on maturity of the deposit. On 13 May 1991 the principal and interest were converted back from Deutsche marks to \$4,639,136. This sum was subsequently paid to B Limited as partial repayment of the balance due on current account.

8. On 23 December 1996 the Commissioner confirmed the additional profits tax assessment on the grounds that:

- (1) The Company's bank accounts are essentially a matter of capital and the exchange loss, being a loss of a capital nature, was specifically prohibited from deduction under section 17(1)(c) of the IRO; and
- (2) The Company had not carried on any trade or business of dealing in foreign currencies.

9. The Company, through the Representative, lodged a valid appeal against the Commissioner's decision on the ground that the foreign exchange loss should be deducted in the computation of its assessable profits having resulted from an adventure in the nature of trade.

### **Evidence of the Managing Director, Mr C**

The managing director of the Company, Mr C, gave sworn evidence before us. We found him to be a competent witness. On the basis of the evidence and from the documents placed before the Board, we find the following additional facts.

10. Mr C was at all relevant times a director of the Company and was its sole managing director. For 13 years up to 1987 he was the general manager of Bank D in Hong Kong. During this time he was actively engaged in international business and foreign exchange dealings on behalf of the bank. He was responsible for the Company's decisions in relation to the transaction in dispute.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

11. Apart from investing in several subsidiary companies Mr C stated that the Company was formed with the intention to engage in various types of profit making activity including buying and selling shares and foreign exchange. In the result, it did not engage in any share dealing activity and its sole foreign exchange transaction gave rise to the loss in dispute. Apart from receiving a management fee and commission,<sup>1</sup> and entering into the transaction in dispute, the Company operated as an investment holding company having treasury functions. Specifically, it used the funds it received from its holding company to finance the activities of its subsidiary companies (compare fact 12).

12. At all relevant times:

- (1) apart from its investment in subsidiary companies, the Company's only major assets were (a) bank time deposits (\$4,671,583 in 1991; nil in 1992) and (b) amount due from subsidiary companies (\$10,379,500 in 1991; \$11,846,446 in 1992). Both these assets were recorded as current assets in the Company's balance sheet;
- (2) the Company's only major liability was an amount due to its holding company (\$16,223,456 in 1991; \$12,133,505 in 1992). This asset was recorded as a current liability in the Company's balance sheet; and
- (3) the Company's only major operating expense recorded in its profit and loss account was the foreign exchange loss in dispute.

13. A major business activity of B Limited is knitwear manufacturing. As this business tends to be seasonal, at various times certain companies in the group may have surplus funds or, conversely, may need additional funds at peak periods.

14. In January 1991 Mr C decided that the Company should use the proceeds of its Hong Kong dollar time deposit to purchase Deutsche marks. Mr C chose to purchase this currency because it was a strong hard currency in preference to, say, the Italian lire that offered higher interest rates at the time.<sup>2</sup>

15. When the Company purchased the Deutsche marks, Mr C expected that the Deutsche mark would increase in value vis-à-vis the Hong Kong dollar. It did not and the Deutsche marks were sold four months after their purchase at a considerable loss. The Deutsche marks were not sold earlier because Mr C expected that the exchange rate might improve and B Limited had no pressing need for funds. They were, however, ultimately sold in May 1991 because Mr C then considered that the exchange rate could get even worse. Furthermore, Mr C stated that at this time some of the subsidiary companies needed additional funds. Mr C's evidence in this regard was somewhat confusing. He could not

---

<sup>1</sup> Details relating to the nature of the activities giving rise to these receipts were not placed before us.

<sup>2</sup> Mr C could not recall but believes that the interest rate payable on a Deutsche mark fixed deposit at the time of purchase was approximately the same as that payable on a Hong Kong dollar fixed deposit.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

recall which of the B Limited's companies needed additional Hong Kong dollar funds. In the result we find that the funds were actually used by the Company to repay its parent company (compare fact 7) and were not paid directly by the Company to any subsidiary company. There is insufficient evidence before us to state how the parent company subsequently used those funds.

16. In cross-examination, it was specifically put to Mr C that the transaction in dispute was simply an investment in foreign exchange rather than a dealing. Mr C denied this and stated that the Company purchased the Deutsche marks with an expectation of selling them at a profit.

17. When asked why the Company did not subsequently enter into any other foreign exchange transaction apart from the one in dispute, Mr C replied that after the loss was incurred he realized he did not have the detailed foreign exchange information available to him while working in the bank and he adopted a more conservative approach.

18. At the time of purchasing the Deutsche marks B Limited had no operational need for this currency. Nor did it envisage such a need. The transaction in dispute was not entered into for hedging purposes.

### **Contentions for the Company**

On behalf of the Company, the Representative argued that:

- (1) The loss on foreign exchange was not a loss of a capital nature and it was wrong for the Commissioner to treat the dealing in foreign currency as if it simply involved a change to the Company's bank account. The time deposit was shown separately from cash at bank in the Company's balance sheet and had never constituted a bank account in the general sense of the term.
- (2) In any event, the Company's transaction in foreign exchange was an adventure in the nature of trade and therefore the loss incurred should be taken into account in computing the Company's assessable profits.

### **Contentions for the Commissioner**

The Commissioner, represented by Mr J R Smith, argued that:

- (1) The loss on foreign exchange arose from the conversion of a time deposit bank account balance. On the authority of CIR v Li & Fung Ltd (1980) 1 HKTC 1193 the loss in question is a loss of a capital nature. The Company simply advanced part of its capital funds to the bank to earn interest on time deposit and the loss incurred on conversion of the funds to Hong Kong dollars was a capital loss precluded from deduction under section 17(1)(c) of the IRO.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

- (2) There is no cogent evidence that the Company entered into an adventure in the nature of trade.

### **Analysis**

This case is an interesting one, not least because the parties took very different approaches in their submissions before us. From the outset the Commissioner has argued that a bank account is essentially an item of capital (see CIR v Li & Fung Ltd and the cases cited therein) and therefore the loss on the time deposit is of a capital nature, precluded from deduction by section 17(1)(c). The Company, while not accepting this argument on the facts before us, simply argued that the loss arose from an adventure in the nature of trade. We deal with both these arguments in turn.

#### The nature of the foreign currency time deposit

As will be shown below, we reject the suggestion that the foreign currency time deposit was taken out for an investment purpose. In these circumstances, for a speculative (to use a neutral term) purpose, cannot in our view simply be equated with a typical bank account balance which has been described, as Mr Smith pointed out, as quintessentially a capital asset.

In our view, the facts of this appeal are far removed from those of CIR v Li & Fung Ltd where the foreign currency (US dollars) was received in the normal course of business (it represented receipts from trade debtors) and where there were specific findings of fact by the Board that the funds ‘were accumulated [for a long period of time] ... and eventually remitted back to Hong Kong at an opportune time’ and ‘were placed on short term deposits to earn interest during the period of the pendency of the [calculated exchange] risk.’ Unlike CIR v Li & Fung Ltd, the issue before us is not whether the foreign currency assumed the nature of capital when it was accumulated over time<sup>3</sup> and placed on deposit with the intention of obtaining more interest and more favourable exchange rates. Rather, the issue is whether, when the Company purchased the foreign currency, did it do so with the intention of selling it at a profit.

#### Adventure in the nature of trade

The law in this area is so well settled that neither party cited authority in their arguments before us. Suffice to say that the issue for our decision, bearing in mind the Company’s burden of proof set out in section 68(4), is whether the Company as a matter of objective fact purchased foreign currency with the intention of reselling at a profit (Simmons v IRC (1980) 53 TC 461). If it did, then the loss would arise from an adventure in the nature of trade and should be taken into account in computing the Company’s assessable profits.

---

<sup>3</sup> This was the finding of fact that Garcia J highlighted before reaching the conclusion that the relevant sums were surplus to the company’s requirements for trading purposes and were thus of a capital nature: see [1980] 1 HKTC 1193 at 1212.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

We accept Mr C's oral evidence that essentially the foreign currency was purchased with the intention to resell at a profit. Mr Smith could only point to two factors which cast doubt on this evidence. The first, which we accept, is that at best Mr C's evidence relating to the need for conversion of the funds (he stated that the funds were needed by subsidiary companies) was vague (see our findings at fact 15). Nonetheless, we have found that the Company operated as a holding company with treasury functions and that needs for funds within the group were seasonal (see facts 11 and 13). In these circumstances we believe that the Company's funds loaned to it by its parent could be repayable at short notice. Indeed, the loans were on current account and the proceeds of converting the Deutsche marks to Hong Kong dollars were used to repay the loans advanced by the Company's parent (see fact 7).

The second factor, which we do not accept, is that given Mr C's background and expertise this transaction is inconsistent with trading because the Company has only ever entered into one foreign exchange transaction. In this regard, Mr Smith even suggested that if the transaction had concerned commodities for which Mr C had no expertise, then an adventure in the nature of trade would have arisen. We see no rationale for discriminating in this way. In any event, we accept Mr C's explanation that after the Company had incurred the large loss he became more cautious in his approach and realised that his specialised knowledge in this field was out-dated (see fact 17).

We now test Mr C's evidence against the objective facts. Typically this is undertaken by reference to the so-called badges of trade. Although certain badges are neutral (the subject matter) or inapplicable (supplementary work), and one factor is against the Company (lack of recurrence), the basic facts are that the Company used short-term borrowed money, for which periodically there are group needs, to purchase foreign currency and then resold this within the short period of four months. Unlike an investor who might be expected to take a more cautious approach, the Company committed a substantial amount, over \$5,000,000, to this transaction. The funds were liquid: a time deposit of one month is short-term in nature and, in any event, the deposit could be broken. The Company and B Limited had no operational need for Deutsche marks at the time of purchase; nor was such a need envisaged. In our view, the transaction giving rise to the loss in dispute was entered into on a short-term basis for the purpose of making a profit from the purchase and sale of foreign currency.

Cases such as the one before us are, of course, dependent upon their individual facts. In this regard, we are satisfied that Mr C's oral evidence is supported objectively and that the Company purchased foreign currency with the intention to resell at a profit. In other words we conclude on the basis of all the facts before us that when the Company purchased Deutsche marks it was not investing in foreign currency; rather it was doing a deal.

Finally we venture to ask what view the Commissioner, having now had the opportunity of hearing Mr C's evidence, would take if the Company had made a gain rather than a loss from its foreign exchange transaction. In our view the Commissioner would be entirely justified in assessing the gain to profits tax and should not be constrained by the fact



## INLAND REVENUE BOARD OF REVIEW DECISIONS

that the gain arose from an isolated transaction and that the Company had no systematic and habitual dealings in foreign exchange. The absence of these factors, though relevant, could not of themselves determine whether the Company had carried on an adventure in the nature of trade.

For all the above reasons we allow the Company's appeal.