[A. LOIZOU, J.]

IN THE MATTER OF ARTICLE 146 OF THE CONSTITUTION

KOUMIPA LIMITED,

Applicant,

and

1. THE REPUBLIC OF CYPRUS, THROUGH THE MINISTER OF FINANCE,
2. THE COMMISSIONER OF INLAND REVENUE,

Respondents.

(*Case No.* 83/75).

Income Tax—Exchange profit—Profit realised on exchange rate on repayment of a loan—Purpose of the loan the acquiring of circulating capital and not fixed capital—Exchange profit which accrued a trading profit and not a receipt of a capital nature—Subject to income tax—Section 5(1) *of the Income Tax Laws,* 1961 *to* 1973.

The applicant company was incorporated on the 16th September, 1966 for the purpose of buying, at Famagusta, plots C 128 and C 129 and erecting thereon a block of flats and shops for sale. As the company had no sufficient cash in hand for the purpose of completing the construction of the block of flats, on the 27th November, 1967 they raised a loan of £70,000 from Barclays (Overseas) Development Corporation Ltd., of London. This loan was payable in Pound Sterling, by 23 monthly instalments of £5,000, plus any accrued interest, the first instalment being payable on the 31st of March, 1969. The construction was completed and the flats and shops sold by the 31st December, 1970.

Because of the difference in the exchange rate, during the repayment period of the loan, the applicant company required a smaller amount in Cyprus Pounds to pay the 1973 instalments. As a result, the liability of the applicant Company towards their creditor was reduced and there was an increase in their balance as against that liability which was equivalent to the sum of £2,164.

The respondent Commissioner treated this amount as a trading profit and, consequently, taxable, and claimed the amount of £785.825 mils as income tax.

In a recourse against the validity of this decision counsel for the applicant contended that the exchange profit which resulted to them was not a trading profit but a capital profit not subject to tax.

Held, (1) that Barclay's International were trade creditors and repayments of instalments to them on the loan contracted were trade outgoings; that as the purpose of the loan from the outset was to be made and was made part of the circulating or trading capital of the applicant Company, the profit which accrued was reduction in the Company's liabilities in respect of repayments due to the change in the rate of exchange; that it was a trading profit and not a receipt of a capital nature giving rise to a corresponding indebtedness on capital account and not forming part of the Company's trading receipts or liabilities.

(2) That the loan was contracted for the purpose of acquiring stock which is a circulating capital and not fixed capital and the profit realised on the exchange rate is, accordingly, assessable to tax because the loan was made for the purpose of carrying out an intended commercial transaction and not for the purpose of investing money.

Application dismissed.

Cases referred to:

McKinley v. *H. T. Jenkins & Sons Ltd.* [1926] 10 T.C. 372;

Imperial Tobacco Co. (of Great Britain and Ireland) Ltd. v. *Kelly*, 25 T.C. 292 C.A.;

Davies (H. M. Inspector of Taxes) v. *The Shell Company of China Ltd.*, 32 T.C. 133;

Landes Bros. v. *Simpson*, 19 T.C. 62;

Van Den Berghs Ltd. v. *Clark (Inspector of Taxes)*, 19 T.C. 390 at p. 431.

Recourse.

Recourse against the validity of an income tax assessment raised on applicant for the year of assessment 1974.

R. Stavrakis, for the applicant.

A. Evangelou, Counsel of the Republic, for the respondent.

Cur. adv. vult.

The following judgment* was delivered by:-

A. LOIZOU, J.: By the present recourse the applicant Company seeks a declaration that the assessment No. 2. 78/Ad/75/74 made on them, is null and void and of no effect whatsoever, and/or that the decision of the respondents to impose income tax on them amounting to C £ 785. 825 mils for the year of assessment 1974, is null and void and of no effect whatsoever.

The only ground of law relied upon by the applicant Company, is that the sum of C £ 2, 164 which resulted from the difference in exchange between the Cyprus Pound and the Pound Sterling on the repayment of a loan contracted by the applicant Company, was not a receipt made from a trading operation or activity or a receipt assessable to income tax, under section 5(1) of the Income Tax Laws, 1961 to 1973.

The applicant Company was incorporated on the 16th September, 1966 for the purpose of buying, at Famagusta, plots C 128 and C 129 and erecting thereon a block of flats and shops, for sale.

The objects of the Company, as appearing in the Memorandum of Association (*exhibit* 'A'), are wider, in the sense that the acquisition of land and buildings, their exploitation and the construction thereon of buildings for sale and exploitation, are not confined to the acquisition of the aforesaid two plots only.

The capital of the Company was £ 100, 000, divided into 100, 000 Ordinary Shares of £ 1.- each. Fifty per cent of the shares were obtained by Constantinos and Irene Koumoulli and fifty per cent, by Ioannou & Paraskevaides Ltd. . The paid-up capital of the Company was £ 41, 000, out of which £ 20, 000 went towards the purchase of the two plots in question, and the remaining cash was utilized for the construction of the block of flats and shops.

On the 23rd January, 1967, the applicant Company agreed with a firm of building contractors, to have the said block, consisting of 27 flats and 12 shops, constructed at a cost of £138,500. It was expected to cover the cost of construction from the flats that would be sold during construction. They started with £20,000 cash in hand and £11,000, proceeds from the sale of

* An appeal has been lodged against this judgment which is still pending.

two flats. So, on the 27th November, 1967, they raised from Barclays (Overseas) Development Corporation Ltd., of London, a loan of £70,000. This loan was payable in Pound Sterling, by 23 monthly instalments of £5,000, plus any accrued interest, the first instalment being payable on the 31st of March, 1969. The construction was completed and the flats and shops sold by the 31st December, 1970.

When the loan was raised, the Cyprus Pound and the Sterling were in parity. In fact, they had been so for years and when in 1967 there was a devaluation of the Sterling, the Cyprus Pound followed suit and remained in parity with it, but the same course was not followed in the 1972 devaluation of the Sterling.

Because of the difference in the exchange rate, during the repayment period of the loan, the applicant Company required a smaller amount in Cyprus Pounds to pay the 1973 instalments. As a result, the liability of the applicant Company towards their creditor was reduced and there was an increase in their balance as against that liability which was equivalent to the sum of £2,164.

The respondents treated this amount as a trading profit and, consequently, taxable. In other words, it had to be brought into the computation of the trading profits of the applicant Company, and by this, the tax claimed was £785.825 mils, as it appears from *exhibits* 1 and 2. The applicant Company objected to the said assessment and alleged that the exchange profit which resulted to them was not a trading profit, but a capital profit not subject to tax.

As stated in Simon's Taxes, 3rd Ed. Vol. B, paragraph B.1.1101 under the heading, Fluctuation in Rates of Exchange,

> " It is a general principle that where the profit or loss arises in the course of trading operations, it is taxable as trading income. Where, however, there is a transaction in foreign exchange representing or connected with an investment of capital, the ensuing profit or loss on exchange is not regarded as part of trading operations, but may nonetheless be caught under Schedule D Case VII or as a capital gain.
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> For example, a forward purchase of foreign currency intended for application as on capital account may give

rise to a gain or loss within the capital gains tax system. But a mere repayment as between an original debtor and a creditor of a debt incurred in currency terms, which is not in the course of trading operations, nor (since there is no disposal) a chargeable capital gain, is not liable to tax."

Whether, however, a currency transaction is or is not an incident of trading, is a question to be determined in the light of the particular contractual arrangements. In the case of *McKinley* v. *H.T. Jenkins & Sons Ltd.* [1926] 10 T.C. 372, it was held that the profit on exchange realised was an isolated transaction and that as the profit arising from it was merely an appreciation of a temporary investment, it was not assessable to tax as part of the profits of the Company's trade. In this case, the Company was a marble and stone merchant, to which had been advanced the sum of £20,000 by a firm of builders, for the purchase of marble from Italy. This sum was credited to a bank account in the joint names of nominees of the Company and of an Insurance Company acting as guarantor. In anticipation of buying the marble, six months later, the Company converted the greater part of the £20,000 into lire, but, in in the meantime, the lira had appreciated in value, and as the money was not yet required for the purchase of marble, the Company's nominee, without the Company's knowledge or authority, converted the lire in the joint account back again into Pounds. As stated in Simon (*supra*), p. 442, "It is doubtful, however, whether this case is now a valid authority". It was distinguished in *Imperial Tobacco Co. (of Great Britain and Ireland) Ltd.* v. *Kelly*, 25 T.C. 292, C.A. in which a profit realised on dollar advances by fur commission agents to their principals, was held to arise directly in the course of the firm's business and was, therefore, assessable as a trading receipt.

The case relied upon by the applicant and treated as the leading one on the matter in issue, is *Davies (H. M. Inspector of Taxes)* v. *The Shell Company of China Ltd.*, 32 T.C. p. 133. This was a case where a British Company sold and distributed petroleum products in China. It made a practice of requiring its agents to deposit with the Company a sum of money, usually in Chinese dollars which was repayable when the agency came to an end. It kept these deposits with banks in Shanghai but because of hostilities the Company transforred these sums to the United Kingdom and deposited the sterling equivalents with its parent company which acted as its banker. Owing to the subsequent depreciation of the Chinese dollar with respect to

sterling, the amounts eventually required to repay agency deposit in Chinese currency were much less than the sums held by the Company to meet the claims, and a substantial profit accrued to the Company. It was decided that these deposits were held as part of fixed capital, so that the exchange profit was a capital profit not assessable to income tax.

Learned counsel for the applicant Company has stressed the fact that in the *Davies* case, the deposits repayable when the agency came to an end, had the character of a loan in that it was repayable at the determination of the agency by the Company and, also, in that it had to carry interest at a fixed rate per cent per annum and with the conversion of the dollars into sterling and their repayment in dollars which brought a profit of exchange was not a necessary incident of the agreement to hold the deposits, or by any means necessarily within the contemplation of the parties. I have been referred to the passage of Jenkins, L.J. at page 148, where it is stated:

> " The exchange profit ultimately realised by the Company, whether it is to be considered as a trading profit or a capital profit, was therefore not a necessary incident of the deposit agreements at all. It was a fortuitous circumstance resulting from the disturbed conditions in China, the consequent conversion by the Company into sterling of its dollar balances, the decline in value of the dollar as compared with the pound owing to those disturbed conditions, and the consequent ability of the Company to purchase dollars sufficient to pay off its agents at less than the sterling equivalent it had realised when it had converted its deposits into sterling."

Relying on this passage, learned counsel argued that even if the exchange profit in our case could be considered as a trading profit, it could not be taxable because it was not an incident of the agreement and, therefore, it could not be within the contemplation of the parties at the time that this profit would accrue. In further support of this proposition, he referred to the *McKinley* case, and the fact that the exchange profit was not taxable as being an isolated transaction which the Company could do, but was not part of the trading business of the Company.

The case of *Landes Bros.* v. *Simpson*, 19 T.C. 62 was referred to also, in order to show that an exchange profit could be subject

to tax if it was part of the trading activities of the Company, whereas it is claimed that in our case, the raising of a loan had nothing to do with either the sale of flats or shops or the income to be received thereunder.

As pointed out in the *Davies* case (*supra*) p. 151 regarding the *Landes* case,

> " The decision was that the exchange profits arose directly in the course of the appellants' business with the company and formed part of the appellants' trading receipts for the purpose of computing their profits assessable to Income Tax under Case I of Schedule D."

From the *Davies* case, however, I find relevant the following passage, at p. 154:

> " It is clear I think that under the terms of the deposit agreements the Company was under no obligation to segregate the deposits from its other assets or earmark as between itself and the depositors any particular funds for the purpose of providing for the deposits. It was free to use the sums in question as it liked in its business in any way though it remained of course subject to the obligation of repaying these in the event of the agencies being brought to an end.
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> As I have said, Sir Andrew Clark contends that that is an irrelevant consideration, and I agree with him, subject to this reservation: The Company might conceivably have used these deposits in such a way as to mingle them with the capital employed in its trading in petrol and petroleum products. It might have invested the deposits in the purchase of petroleum, treating the depositors as trade creditors, the deposits as trade receipts, and repayments of deposits as trade outgoing. If that had been so then it might well have been said, it seems to me, that whatever the nature of the transaction was at the outset the Company had so dealt with the deposits in question as to make them part of its circulating or trading capital, with the result that any profit which accrued through reduction in the Company's liabilities in respect of the deposits owing to the alteration in the rate of exchange could be nothing else but a trading profit. But nothing of that sort happened here and as appears from what I have already said, in fact and in practice the Company at all times kept, at first in

China and afterwards with its parent company in England, deposit accounts covering the amounts of the agents' deposits. That is consistent with a view on the part of the Company that the amounts of these deposits should be treated as something apart from the circulating capital of the Company. It is a course consistent with that view, and at all events I think one can say this, that if, contrary to Sir Andrew Clark's contention, the deposits did not in origin bear the character of trading receipts but were merely in the nature of capital receipts by way of loan, there was nothing in the subsequent dealing by the Company with the deposits, so far as the evidence goes, to impart to them a character of trading receipts which they did not in origin possess."

And the question which had really to be resolved in the *Davies* case was put by Jenkins, L.J. in this way at p. 155:–

"On the facts of this case, were these deposits trading receipts received by the Company in the course of its trade, and giving rise to corresponding trade liabilities in the form of the Company's obligation as to repayment, or should they be regarded simply as loans received by the Company and thus as receipts of a capital nature giving rise to a corresponding indebtedness on capital account and not forming part of the Company's trading receipts or liabilities at all?"

Of course, in the *Davies* case, the deposits in question were treated, as a matter of fact, as fixed capital. Had it been found that the deposits had been a circulating capital, the decision might have been different, and this appears from the judgment of Lord Jenkins at p. 156 –

"If the agent's deposit had in truth been a repayment in advance to be applied by the Company in discharging the sums from time to time due from the agent in respect of petroleum products transferred to the agent and sold by him the case might well be different and might well fall within the ratio decidendi of *Landes Bros.* v. *Simpson* and *Imperial Tobacco Co.* v. *Kelly*. But that is not the character of the deposits here in question. The intention manifested by the terms of the agreement is that the deposit should be retained by the Company carrying interest for the benefit of the depositor throughout the terms of the agency. It

is to be available during the period of the agency for making good the agent's defaults in the event of any default by him; but otherwise, it remains, as I see it, simply as a loan owing by the Company to the agent and repayable on the termination of the agency; and I do not see how the fact that the purpose for which it is given is to provide a security against any possible default by the agent can invest it with the character of a trading receipt."

That they were treated as part of the Company's fixed and not of its circulating capital, it appears from the following passage at p. 157:–

> " As loans it seems to me they must *prima facie* be loans on capital not revenue account; which perhaps is only another way of saying that they must *prima facie* be considered as part of the Company's fixed and not of its circulating capital. As appears from what I have said above, the evidence does not show that there was anything in the Company's mode of dealing with the deposits when received to displace this *prima facie* conclusion."

In our case, the loan was contracted for the purpose of acquiring stock which is a circulating capital and the profit realised on the exchange rate is assessable to tax, because the purpose for which the loan was made was to carry out an intended commercial transaction, that is, to build and sell flats and not to build flats as an investment. In other words, it was a loan contracted for the purpose of acquiring circulating capital and not fixed capital for the purpose of carrying out a commercial operation and not for the purpose of investing money. In fact, though that is not conclusive, it was not so treated by the applicant Company itself, as the interest payable on this loan was treated as a deductible expense for the computation of profits resulting from the sale of the flats.

That exchange profits arising in the course of the trade and giving rise to corresponding trade liabilities in the form of the tax payers obligation as to repayment are taxable as trading profits is clear also from the *Davies* case (*supra*) where the case stated was to the effect that the deposits in that case were part of its fixed capital and did in fact so use them and not as circulating capital for the purpose of carrying on its trade, whereas in the present case the loan was contracted for the

simple reason of forming part of its circulating capital for the purpose of carrying on its trade.

I need not go in detail into the differentiations made by economists between fixed and circulating capital. It is sufficient to refer to the *Davies* case (*supra*) at p. 153, where by reference to Adams Smith who described fixed capital as what the owner tends to profit by circulating capital is what he makes profit of by parting with it and letting it change masters, and as put by Lord McMillan in the case of *Van Den Berghs Ltd.* v. *Clark* (*Inspector of Taxes*), 19 T.C. 390 at p. 431. "Circulating capital is capital which is turned over and in the process of being turned over, yields profit or loss. Fixed capital is not involved directly in that process and remains unaffected by it".

Bearing in mind the facts and circumstances of this case and the aforesaid exposition of the law, I have come to the conclusion that Barclays International were trade creditors and repayments of instalments to them on the loan contracted were trade outgoings. Furthermore, as the purpose of the loan from the outset was to be made and was made part of the circulating or trading capital of the applicant Company, the profit which accrued was reduction in the Company's liabilities in respect of repayments due to the change in the rate of exchange; it was a trading profit and not a receipt of a capital nature giving rise to a corresponding indebtedness on capital account and not forming part of the Company's trading receipts or liabilities, as things were in the *Davies* case (*supra*, at p. 155 of the report).

For all the above reasons, the present recourse fails, but in view of the novelty of the points raised, I make no order as to costs.

Application dismissed.
No order as to costs.