Case No. D17/87

Board of Review:

Charles A. Ching, *Chairman*, J. D. Mackie and Maximilian Y. K. MA, *Members.*

28 July 1987.

Profits Tax—Sections 14 and 15(1)(*g*) of the Inland Revenue Ordinance—whether interest earned from the "clients account" was in respect of the funds of the profession and assessable profit.

The Appellant is a firm of solicitors practicing in Hong Kong. From time to time it received sums of money which it deposited into its clients' account. Interest was earned. The Appellant kept the interest and eventually distributed amongst its partners. The Appellant was assessed to profits tax on such interest under the provisions of Sections 14 and (15)(1)(*g*) of the Inland Revenue Ordinance. The Appellant appealed.

The point at issue is whether or not the interest was in respect of the funds of the profession. The Commissioner found that the interest was assessable profit arising out of or deriving from the Appellant's professional activities under Section 14 of the Inland Revenue Ordinance because:—

(1) The intake and disbursement of clients' funds are part of a solicitor's normal profit.

(2) The interest was credited to the Appellant's accounts as part of its receipts from its practice.

(3) The interest was distributed amongst the partners in a manner no different from the distribution of other profits of the firm.

(4) The Appellant's treatment of the interest accorded generally with the practice adopted by other solicitors in Hong Kong.

The Commissioner also relied upon the deeming provision under Section 15(1)(*g*) of the Inland Revenue Ordinance as he had found that the interest was in respect of the funds of the profession.

Held:

The interest did not form part of the professional profits and it arose from the separate agreement with the bank and the solicitors were entitled to it by reason of an agreement with their clients. The interest was therefore not assessable profit under Section 14 of the Inland Revenue Ordinance. To bring the interest within Section 15(1)(*g*) of the Inland Revenue Ordinance the interest would have to be in respect of the funds of the profession. The funds did not belong to the Appellant as they were the funds of the clients.

Appeal allowed.
(Note: The Commissioner has subsequently appealed to the High Court.)

Cases referred to:

Brown v. I.R.C. [1964] 3 All ER 119
Joachimson v. Swiss Bank Corpn [1921] 3 KB 110
Northend v. White & Leonard & Corbin Greener 50 TC 121

D. O'Dwyer for the Commissioner of Inland Revenue.
S. W. Lau of M/s Lau, Wong & Chan for the Appellant.

Reasons:

The taxpayer is a firm of solicitors practicing in Hong Kong. As such it received from time to time sums of money which it deposited into its clients' account. Interest was earned which the taxpayer kept and which it eventually distributed amongst its partners. The taxpayer was assessed to profits tax on the interest for the year 1983/84 and to additional profits tax for the years 1981/82 and 1982/83.

Save for one matter the facts were not in dispute. The dispute was whether or not the whole of the capital in the clients' account belonged to the taxpayer's clients or whether some of it belonged to the taxpayer. It is clear from Rules 3 to 6 of the Solicitors Accounts Rules, Cap. 159, that generally clients' money is to be kept separte from the solicitor's money. Paragraph 17.20 of the Professional Conduct of Solicitors enjoins solicitors to pay sums out of clients' account as soon as they are properly payable. The taxpayer explained that in the three years in question there would have been in the region of 9 000 receipts and possibly more withdrawals of clients' funds so that administratively it was impossible to analyse the amounts standing in the account. We bear in mind the duty of any taxpayer to keep proper accounts but there is nothing before us to indicate that the taxpayer conducted its practice in any way contrary to the rules and etiquette of its profession. If any part of the money in the clients' account became the taxpayer's beneficially it could therefore only have stayed in that account for a short time. We therefore find that any capital sums in the taxpayer's clients' account belonged to its clients.

The entitlement of a solicitor in Hong Kong to interest earned on clients' account comes about as follows. For many years both in England and in Hong Kong for solicitors to keep that interest unless a client specifically instructed that any interest was to accrue to him. The question came before the House of Lords in *Brown vs. I.R.C.* [1964] 1 A.E.R. 119 which effectively reversed the position in England. As a result of that decision Section 8 of the Solicitors Act, 1965, was passed enabling solicitors to keep the interest under certain circumstances. There has been on equivalent legislation in Hong Kong. Instead, on the recommendation of a sub-committee of the Law Society the practice now is that in appropriate cases clients are asked to sign a retainer form which contains provisions that in given circumstances the interest is to belong to the solicitor. Those provisions also appear on the backs of the solicitors' receipts. In Hong Kong, therefore, the solicitors entitlement to the interest is wholly a matter of contract. On one view this may cause an admixture of the solicitor's money (the interest) with the client's money (the capital) contrary to the Rules. We think the better view is that the interest does not become the solicitor's money until it

can properly be withdrawn under Rule 7 in the same way as withdrawal of funds paid in advance for fees.

It is clear to us that no interest tax is assessable upon the sums in question. Section 28(1), which is the first section in Part V of the Inland Ordinance, Cap. 112, provides that

> "Interest tax shall, subject to the provisions of this Ordinance, be charged for each year of assessment on the recipient of any sum paid or credited to him in that year being—
>
> (*a*) interest arising in or derived from Hong Kong on any … deposit, loan, advance or other indebtedness …'

The deposits of clients' funds into a bank must come within the word "deposit". Further, deposits into a bank are loans or advances from the customer to the bank—see *Joachimson vs. Swiss Bank Corpn.* [1921] 3 K.B. 110. Interest tax would therefore have been payable but for proviso (*a*) to that section which exempts

> "any interest paid … by a bank licensed under the Banking Ordinance …"

The hearing proceeded on the basis that the deposits were with a bank and we have no reason to doubt that that bank was properly licensed under the Banking Ordinance.

The Commissioner in his Determination held that the interest was assessable to tax under the provisions of section 14 and 15(1)(*g*). Section 14 provides that

> "Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part."

At the time, section 15(1)(*g*) provided that

> "For the purposes of this Ordinance, the sums described in the following paragraphs shall be deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong—
>
> (*g*) sums received by or accrued to a person, other than a corporation, carrying on a trade, profession or business in the Colony by way of interest derived from the Colony which interest is in respect of the funds of the trade, profession or business and is exempt from interest tax under Part V."

We have already found that the interest was exempt from interest tax. So far as section 15(1)(*g*) is concerned it therefore remains only to consider whether or not the interest was 'in respect of the funds of the … profession …'.

We find that the interest does not fall within the deeming provisions of section 15(1)(*g*). To do so the interest would have to have been in respect of the funds of the profession. The funds did not belong to the taxpayer: They were the funds of clients. The interest on those funds did not belong to the taxpayer until it was properly paid out under Rule 7. In rejecting the taxpayer's claim under this heading the Commissioner sought to distinguish the decision in *Northend vs. White & Leonard & Corbin Greener* 50 T.C. 121. In that case a solicitor had received clients' funds which were then placed on interest bearing deposit. The solicitor applied for relief from taxation on that interest on the grounds that it was not "immediately derived" from the carrying on of his profession or vocation. The Court held that he was entitled to relief. The money was not immediately derived from the solicitor's profession or vocation but from the separate contract between the solicitor and the bank. The Commissioner distinguished this decision on the basis that the English legislation was for relief from taxation if it could be shown that the interest was "immediately derived" from the profession or vocation. We agree that if the wording had been material the case is distinguishable. The ratio of the decision, however, was that the interest was not derived from the profession or vocation at all but from the separate agreement with the bank. In that respect it is indistinguishable from the present case. In any event, as we have already found, the interest did not arise from the funds of the profession.

Section 15(1) is merely a deeming section and is not exhaustive as to what is or is not assessable profit. The Commissioner found that the interest was assessable profit under section 14 because:—

(1) The intake and disbursement of clients' funds are part of a solicitor's normal profit.

(2) The interest was credited to the taxpayer's accounts as part of its receipts from its practice.

(3) The interest was distributed amongst the partners in a manner no different from the distribution of other profits of the firm.

(4) The taxpayer's treatment of the interest accorded generally with the practice adopted by other solicitors in Hong Kong.

We regret that we must hold that we cannot regard any of these matter as bringing the interest within section 14.

We accept that the intake and disbursement of clients' funds are part of a solicitor's normal practice. However, there is no suggestion that the interest earned on the deposit of clients' funds represented a charge levied by the taxpayer for the purposes of dealing with those funds. We accept also that the taxpayer credited the receipt of the interest as part of its receipt from its practice. By itself, or even taken with the other reasons, this cannot bring the interest within section 14. The character of the receipt cannot be determined by any label put upon it. We also accept that the interest was distributed amongst the partners in a

manner no different from the distribution of other profits from the firm. We do not think that this is relevant. The taxpayer is a partnership of solicitors and it is proposed to tax upon the basis that that partnership earned profits by way of interest as part of its profession. We think it is clear that the interest did not form part of the professional profits any more than, say, if the partners had agreed to use part of the profits of the firm to speculate on the commodities market. The interest arose from the separate agreement with the bank and the solicitors were entitled to it by reason of an agreement with their clients. Finally, we do not accept that it is relevant to consider how other solicitors may or may not have dealt with the same question. The only question before us is whether or not the interest is, at law, assessable to profits tax.

A large number of authorities was cited to us. We do not think it is necessary to refer to them. We find that the interest was not assessable profit arising out of or deriving from the taxpayer's professional activities. We find that the interest arose out of or was derived from a separate agreement which the taxpayer made with the bank. In all of the circumstances we therefore allow the appeal.

Another matter which caused us some concern at the beginning of the hearing was the state of the notice of appeal from the Commissioner's Determination. That Determination was dated 29 November 1985. Under cover of a letter dated 6 December 1985, the taxpayer sent to the Clerk of this Board a document headed "Statement of Appeal". It simply read

> "(The taxpayer) hereby appeals against the determination of the Commissioner in respect of the objection to the Additional Profits Tax for the years 1981/82 & 1982/83 and Profits Tax Assessment for this year of assessment 1983/84 on the ground that the Commissioner has erred in law as well as in facts in his determination."

No particulars of any alleged errors of law or of fact were given. The taxpayer took the view that the hearing was an informal one and that particulars need not be given. We must emphasise that this is quite wrong. Section 66(1) of the Inland Revenue Ordinance, Cap. 112, lays down the time within which an appeal is to be lodged and requires that no notice shall be entertained unless it is accompanied by

> "… a statement of the grounds of appeal."

Section 66(2) requires that statement to be served on the Commissioner and section 66(3) provides that

> "Save with the consent of the Board and on such terms as the Board may determine, an appellant may not at the hearing of his appeal rely on any grounds of appeal other than the grounds contained in his statement of grounds of appeal given in accordance with subsection (1)."

It is not to be thought that such leave will be given as a matter of course. We also had severe doubts as to whether the "Statement of Appeal" constituted a valid notice of appeal at all and we were conscious of the decision in BR19/71, HKIRBRD 58, which is authority that the Board has no power to extend the time for filing grounds of appeal. Mr. O'Dwyer, who

appeared with Mr. Grady for the Inland Revenue Department, did not object to an adjournment for the purposes of proper grounds of appeal being presented. We assented to an adjournment for that purpose mainly because the point raised is an important one and, so far as we are aware, one which has not been considered in Hong Kong before. We reserved the question of costs occasioned by that adjournment, but having regard to the fact that we uphold this appeal we have no power to order such costs to be paid by the taxpayer.