IN THE COURT OF APPEAL

1994, Nos. 4 & 5
(Inland Revenue)

BETWEEN

Orion Caribbean Limited (in voluntary liquidation) — Appellant

and

Commissioner of Inland Revenue — Respondent

Coram : Hon. Godfrey, Ching, JJ.A. & Leonard, J.

Dates of hearing : 10, 11 & 12 January 1996

Date of handing down judgment : 2 February 1996

J U D G M E N T

Godfrey, J.A. (giving the judgment of the court) :

Introduction

In this appeal we are called on to resolve a dispute, about profits tax, between Orion Caribbean Limited, in voluntary liquidation ("the taxpayer"), a company incorporated in the Cayman Islands but which carried on business in Hong Kong, and the Commissioner of Inland Revenue ("the Commissioner"). In order to explain the issues which divide the parties, it is necessary to state first the relevant charging provisions in the Inland Revenue Ordinance, Cap.112 ("the Ordinance") upon the true effect of which the resolution of the dispute depends.

The charging provisions

By section 14 of the Ordinance, profits tax is chargeable, for each year of assessment, 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* (emphasis added) for that year from such trade, profession or business.

By section 15(1)(i) of the Ordinance, sums, not otherwise chargeable to profits tax, received by or accrued to *a financial institution* (emphasis added) by way of interest, which arise through or from the carrying on by the financial institution of its business in Hong Kong, notwithstanding that the moneys in respect of which the interest is received or accrued are made available outside Hong Kong, are deemed, for the purposes of the Ordinance, to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong. (In other, simpler, words, such sums are brought into the charge to profits tax imposed by section 14.)

The issues

The issues, shortly stated, are these :

(1) Are the profits in question (interest receipts on the loan of moneys made available outside Hong Kong), which the Commissioner seeks to tax, profits "*arising in or derived from Hong Kong*"?

(2) If not, is the taxpayer a "*financial institution*", so that the relevant interest receipts of the taxpayer are to be *deemed* to be receipts arising in or derived from Hong Kong, despite being receipts of interest on moneys made available outside Hong Kong?

The taxpayer's case

The taxpayer says that its relevant profits did *not* arise in and were not derived from Hong Kong; and that it was not, for the relevant purpose, a financial institution, so that those profits do not fall to be treated as if they *had* arisen in or were derived from Hong Kong.

The Commissioner's case

The Commissioner says that the relevant profits of the taxpayer *did* arise in and were derived from Hong Kong; if that is wrong, the Commissioner says that the taxpayer *was* a financial institution; so that the relevant receipts, even though they *were* receipts of interest on moneys made available outside Hong Kong, are to be deemed for profits tax purposes to have been receipts arising in or derived from Hong Kong.

The proceedings

The dispute between the parties comes before us under s.69A of the Inland Revenue Ordinance, Cap.112, by way of a case stated by a board of review for the opinion of this court. Section 69A enables a taxpayer, or the Commissioner, with the leave of this court, to appeal directly to this court against a decision of a board of review, if in the opinion of this court it is desirable that by reason of the amount of tax in dispute, or the general or public importance of the matter, or its extraordinary difficulty, or for any other reason, the appeal be heard and determined by this court instead of the High Court. On 3 July 1995, Mayo, J.A. gave the required leave. (The order made by Mayo, J.A. recites that it was made "by consent"; but we will assume Mayo, J.A. satisfied himself that the case was suitable for this "leapfrog" procedure, as section 69A requires. Such an order cannot properly be made "by consent".)

The decision of the board of review

The board of review was of the opinion that, on the facts as they found them, the relevant profits of the taxpayer did *not* arise in and were *not* derived from Hong Kong. The taxpayer of course supports this conclusion; the Commissioner opposes it. However, the board was of the opinion that the taxpayer *was* for the relevant purpose a financial institution, so that the relevant receipts are to be *deemed* for profits tax purposes to be receipts arising in or derived from Hong Kong. The Commissioner of course supports this conclusion; the taxpayer opposes it.

The facts

The facts found by the board of review, which are complex, are set out in paragraph 4 of the stated case. It is desirable, in order to prevent any suggestion that this court has overlooked some material fact in coming to its own conclusions upon the case, to set out the board's findings of fact in full. Accordingly, we reproduce paragraph 4 (in which the taxpayer is referred to as "OCL") below :

> "4.1 OCL was incorporated as an exempt company under the laws of the Cayman Islands on 18th July, 1979. It changed its name on 3rd October, 1979 and adopted a new memorandum of association whereby its main objects were amended to include the carrying on of the business of banking and the advancing or lending of money or the grant or provision of financial accommodation with or without security. It commenced business on 10th October, 1979, having on that day obtained a category "B" unrestricted bank licence issued by the Governor of the Cayman Islands which permitted it to carry on a banking business outside the Cayman Islands.

4.2 OCL was wholly owned by a company incorporated in Hong Kong Orion Royal Pacific Limited ("ORPL") which was in turn wholly owned indirectly by a company in London, Orion Royal Bank Limited ("ORBL"); Orion Pacific Holdings Limited ("OPHL") and Orpac Holdings Limited ("Orpac") held 75% and 25% respectively of the shares of ORPL. OPHL was wholly owned by ORBL, who also held 20% of Orpac, the remaining 80% of Orpac being held by RBC Finance BV, a company incorporated in the Netherlands. ORBL was prior to June, 1981 owned by a consortium (of which a bank in Canada, the Royal Bank of Canada ("RBC") was a member) and subsequently wholly owned by RBC.

4.3 ORPL was at first a registered deposit-taking company (DTC) and subsequently a licensed DTC within the meaning of the Deposit-taking Companies Ordinance (DTCO) (since repealed) and the Banking Ordinance (BO) which succeeded it, and was at all times a financial institution within the meaning of section 2 of the IRO. A main purpose of ORPL was to look for business; it did this by calling on companies and state agencies directly. In the late 1970's and early 1980's, ORPL was one of the main institutions or banks active in syndicated loans in Hong Kong; it would on its own or in co-operation with other banks underwrite term loans and syndicate them among other banks in Asia and Europe. All those banks carried on business in Hong Kong. The banking department of ORPL undertook credit analysis, loan syndication, loan management, negotiation of new loan documentation and amendments to existing agreements and loan administration. When a syndicated loan was being put together, the lead bank or banks structured the financial package and handled the negotiations with the borrower on behalf of the lending banks. The place where the negotiations took place depended on the wishes of the borrower. The loan agreement was signed either in or outside Hong Kong. For each syndicated loan there was an agent whose role was to handle post signing events, that is: to set interest rates, request drawdowns and collect contributions from the participating lenders, pay the proceeds to the borrower, calculate and pay commitment fees, front end fees and interest, collect repayments from the borrower and distribute them to the participants, collect from the borrower information due to be supplied under the loan agreement (annual reports, etc.) and distribute it to the participants, pass on to the participants the borrower's requests for waivers and amendments to the loan agreement, and so on.

4.4 A commitment fee is paid to compensate a lender for loss of income during the period when any balance of a loan is undrawn, while front end fees include arrangement fee, participation fee, drawdown fee, praecipium (for finding a borrower) and pool (the unspent portion of front end fees which is divided among lead managers). A borrower knows only the total cost of a

loan; it is a matter between the lead manager and the other lenders how the fees are to be shared.

4.5 OCL's function within the group was to serve as a vehicle for a tax avoidance scheme whereby it borrowed money on a regular basis (in currencies other than Hong Kong dollars) from (a) ORPL until late August, 1985 and (b) the Singapore branch of RBC ("the Singapore branch of RBC") subsequently; and on-lent (again in currencies other than Hong Kong dollars) to borrowers (recommended by ORPL and approved by OCL), thereby making a profit out of the interest differential between the borrowings and the lendings. The borrowers were in the Asia Pacific region and were in all cases outside Hong Kong. OCL's proposition was that by virtue of its offshore position and the way its business was organised and operated, the profits thus made were not subject to profits tax under the IRO. In the words of a witness who was then an associate director of ORPL, the purpose of OCL was 'to shelter certain offshore Hong Kong profits from Hong Kong profits tax'. In the words of another witness who was an officer of RBC: 'whilst the group regards income tax as a normal operating expense, it does not regard tax mitigation as a socially unacceptable activity provided it is done within the regulations and applicable laws'.

4.6 To put the scheme into operation, three preliminary steps were taken:

4.6.1 On 18th October, 1979 OCL and ORPL entered into a service agreement (hereinafter called the service agreement) which contained, inter alia, the following terms:-

'1. OCL shall employ ORPL and ORPL shall serve OCL to perform the following services:-

(a) to provide administrative services in respect of loans and/or loan transactions which OCL may from time to time make or to which it is a party whether alone, or jointly with others, or as a member of a syndicate of banks and other institutions;

(b) to provide administrative services for such of the bank accounts and cash deposits of OCL as it shall direct under such circumstances as shall be agreed between the parties;

(c) to provide such accounting services as OCL may require.

2. ORPL shall in the performance of the services undertake such of the following duties as OCL shall from time to time require:-

(a) the management of the cash and deposits for the time being of OCL provided that cash belonging to OCL may during such time or times as ORPL thinks fit be retained in cash or placed on deposit with any bank or financial institution in any part of the world;

(b) keeping under review the loan and investment portfolio for the time being of OCL;

(c) reporting to the Board of Directors of OCL at quarterly intervals, or as often as the Board shall reasonably require, with such information as the Board may reasonably require relating to the business and affairs of OCL and the activities of ORPL hereunder;

(d) providing or procuring the provision of such statistical and other information on the loan and investment portfolio for the time being of OCL and any changes therein, and on any projects or transactions then under consideration, as may be necessary to enable the Board to report fully to the members of OCL upon the financial, investment and cash position and the potential of OCL in the annual Directors' Report and on such other occasions as the Board may require; and

(e) arranging for the registration of all securities acquired by OCL in the name of OCL, or in the name of such nominee company as OCL shall direct, and for bearer securities to be deposited with such authorised bank as OCL shall direct.

4. Nothing contained herein shall under any circumstances empower or authorise ORPL to negotiate, enter or conclude any contract, loan, investment or undertake as agent any business on behalf of OCL.

5. All expenses incurred by ORPL in or about the performance of its services hereunder, including the costs of

administrative services, especially personnel, secretarial, clerical and office staff and accommodation shall be reimbursed by OCL to ORPL within thirty days of any invoice in respect thereof being rendered to OCL.

6. (a) OCL shall pay ORPL by way of remuneration for its services hereunder a fee at the rate of 5% of the expenses payable under clause 5 hereof.

7. This agreement shall continue in force until terminated by either party on giving to the other party not less than three months written notice of termination. Either party may terminate this agreement forthwith by notice to the other in any of the following circumstances:-

(a) if that other party commits a breach of this agreement, which is not remedied within thirty days after notification thereof to such party in breach; or

(b) if an order is made or an effective resolution passed for the winding up of that other party, otherwise than by means of a members' voluntary winding up, or for the purpose of a reconstruction or amalgamation while solvent, the terms of which shall have been previously approved in writing by the first mentioned party; or

(c) if a receiver or similar officer is appointed of the whole or any part of the undertaking or assets of that other party.

13. The duties of ORPL hereunder shall not preclude ORPL from providing services of a like nature to any other person, firm or corporation.

15. Nothing herein contained shall constitute or be deemed to constitute a partnership or joint venture between the parties hereto.

16. This agreement shall be governed by and construed in all respects in accordance with the laws of the Colony of Hong Kong, and the parties hereby irrevocably submit to the jurisdiction of the Hong Kong courts, but this shall not

prevent either party from enforcing this agreement in any other court of competent jurisdiction.'

4.6.2 On 9th November, 1979 ORPL and a company incorporated in the Cayman Islands RoyWest Trust Corporation (Cayman) Limited ("RoyWest") entered into an agreement which contained, inter alia, the following provisions:-

'... AND WHEREAS each of ORPL and RoyWest is beneficially entitled to some of the shares in OCL, whether held directly or in nominee form AND WHEREAS RoyWest has consented to act as or otherwise provide a Director and Officer or either of them of OCL in the Cayman Islands upon receiving such indemnity as is hereinafter contained AND WHEREAS RoyWest has agreed that during the period in which it performs these functions as a Director and Officer or either of them it shall accept the advice and recommendations of ORPL whether by word of mouth, letter, cable, or telephone and shall arrange for such advice and recommendation to be carried out with the least possible delay.

PROVIDED ALWAYS that actions or omissions based on such advice and recommendations shall comply with the laws of the Cayman Islands, with the powers contained in the Memorandum and Articles of Association of OCL and in other respects shall not be ultra vires or otherwise illegal AND PROVIDED ALSO in particular that RoyWest is satisfied either that the proposed action or omission does not infringe regulations made under the Cayman Islands Exchange Control Regulations for the time being in force or that the written permission of the Controller of Exchange has previously been obtained for such action or omission.

NOW THIS AGREEMENT WITNESSETH that in consideration of these premises:-

1. ORPL hereby covenants with RoyWest that so long as it or any officer, employee or agent of RoyWest acts as Officer or Director of OCL, ORPL will at all times hereafter indemnify it and hold it harmless and keep it indemnified and held harmless from all actions, suits, proceedings, claims, demands, costs and expenses whatsoever which may be taken or made against it, its officers, employees or agents or which may be incurred or become payable by it, its officers, employees or agents, in respect of or arising out of

them or any of them holding any such office or directorship in OCL.

2. ORPL agrees with RoyWest that this indemnity shall be construed and take effect in accordance with the law of the Cayman Islands which shall be the forum for the enforcement hereof and ORPL further agrees to submit to the forum of the Cayman Islands PROVIDED ALWAYS that RoyWest shall not be limited to the forum of the Cayman Islands for the enforcement of this indemnity in the event that any actions or proceedings are instituted against it in another forum in relation to any act or omission to which this indemnity extends AND PROVIDED FURTHER that RoyWest may institute proceedings in respect of this indemnity in any forum where ORPL may from time to time reside or have assets situate and ORPL hereby agrees to submit to any such forum as aforesaid in which RoyWest may seek to enforce or have recourse to this indemnity.'

RoyWest was owned in equal shares by two banks, one of which was RBC.

4.6.3 On 13th November, 1979 ORPL and OCL entered into an agreement whereby ORPL as beneficial owner sold, assigned and transferred to OCL, and OCL thereby purchased and accepted from ORPL, all the right, title and interest of ORPL as a lender to, of and in all the loan agreements, credit agreements, participation agreements and other similar documents as set out in the schedule thereto and all guarantees, promissory notes and other securities for the obligations of the obligors thereunder (the loan documents) and its rights thereunder as a lender to the repayment and payment of all such sums as might become due or owing under the loan documents. The consideration for the loans, 27 in all, due and payable on various dates in 1979 and 1980, aggregated to US$63,846,000 plus DEM2,913,000 plus JPY279,055,000. OCL's capital of US$5,997,500 was utilised as a partial cash payment. The balance of the consideration remained as a loan from ORPL to OCL.

4.7 OCL had two main sources of loan assets: the assigned loans mentioned in paragraph 4.6.3 above, and new syndicated loans which were recommended by ORPL and approved by OCL. To fund the making or renewal of a loan or a part of a loan (that is, a drawdown or rollover), OCL would raise the required funds by taking deposits: until late August, 1985 from ORPL, and subsequently from the Singapore branch of RBC.

4.8 Before a loan was recommended to OCL, the terms would already have been negotiated with the borrower and approved at several levels within the group; the stages in the approval process were as follows:-

4.8.1 Generally speaking, all loans had to be within the country limit.

4.8.2 ORPL would undertake a credit analysis of the borrower which had to be approved by the marketing officer, the credit officer and the managing director of ORPL.

4.8.3 Prior to June, 1981 the loan would then be placed for approval before the external loan committee composed of a representative of each of the five shareholder banks of the consortium; from June, 1981 the loan would be submitted to a credit committee consisting of a senior vice president (Asia Pacific) of RBC in Hong Kong, a member of the senior management of ORBL (who were both directors of ORPL) and the managing director of ORPL.

4.8.4 Upon approval by the credit committee, the loan would be referred to RBC's Asia Pacific headquarters for taxation advice and counsel. If the amount of the loan was beyond the limit of that body for giving advice and counsel, they would then refer it to RBC's head office. In practice, head office approval was required for all the loans made by OCL because of their size, and all three levels of approval were sought simultaneously for each loan.

4.9 Once all approvals had been obtained, ORPL would decide which group company should be approached to take up the loan or participate in the syndicate making the loan. In arriving at this decision, ORPL would have regard to matters such as the loans taken up by OCL to date, future likely loans, the revenue and expense budget of ORPL and the prospects for the rest of the financial year.

4.10 Any recommendation made to OCL would be made at arm's length, that is, on the same terms as the loan would be offered to banks outside the group; for example, the same participation fee would be offered, and any pool or praecipium would be retained by ORPL, as if OCL was a third party bank.

4.11 On the other hand, ORPL had to earn income to cover operating expenses, so it also took up some loans and participated in syndicated loans.

4.12 On 3rd November, 1982 OCL approved only one of four loans recommended by ORPL and rejected the other three. There is no evidence to explain the reasons for the rejection. On all other occasions, OCL's board in the Cayman Islands approved the loans as recommended, and, in doing so, relied on the evaluations of the group committees.

4.13 Having approved a loan, OCL in the Cayman Islands would issue to a director of ORPL (and, after June, 1981, sometimes also to an officer of RBC as an alternative) a power of attorney to execute the loan agreement on its behalf. No evidence was adduced as to where a great majority of these loan agreements were signed. In the case of fourteen of them, their places of signing are known; six of the fourteen were signed in Hong Kong. As a matter of inference, we find that over 40% (in number) of all the loan agreements to which OCL was a party were signed in Hong Kong.

4.14 OCL's main bank account was a US$ account maintained with a bank in New York, as most of its loan transactions were in that currency. In addition, it maintained a Deutschemark account with a bank in Frankfurt, a Japanese Yen account with a bank in Tokyo, and another US$ account with RoyWest in the Cayman Islands. The directors of OCL and persons from time to time on ORPL's list of authorised signatories were authorised to operate OCL's bank accounts. Normally the banks communicated with, and sent their statements, credit advices and debit advices to, OCL care of ORPL in Hong Kong.

4.15 As its paid up capital and reserves were comparatively small, OCL had to borrow money to fund its loan commitments. OCL was not a participant in the money markets and was unknown to any bank outside its own group. ORPL had a treasury unit which raised funds on a daily basis in the international inter-bank money markets in financial centres such as New York, London, Frankfurt, Tokyo, Hong Kong and Singapore. It made loans to OCL (by placing deposits with it) with the funds raised in the money markets. With the deposits taken from ORPL, OCL was enabled to fund the drawdowns and rollovers (loan renewals). Generally, loans made by OCL would be for a number of years while deposits taken from ORPL were short-term with the same maturity date as the rollover. Thus on a rollover, OCL would repay the deposit to ORPL and take another deposit from it. On any given working day, ORPL would raise funds to make loans not only to OCL but also to other borrowers, the funds being fungible (that is, inter-mixed and indistinguishable) in ORPL's books. ORPL would not necessarily raise specific funds to on-lend to OCL but would lend it a portion of the fungible funds, the balance being otherwise deployed. Under the clearing house system, bank transfers of US dollars are made only in New York, Deutschemarks in Frankfurt, Japanese yen in Tokyo, and so on. Thus ORPL

placed deposits with OCL by transferring funds from its bank account in New York, Frankfurt or Tokyo, as the case might be, to OCL's bank account in the same financial centre. Upon repayment, the amount repaid would be transferred from OCL's bank account to ORPL's bank account in the same financial centre. In addition to sending its instructions to its overseas banks to effect such transfers, ORPL also sent instructions on behalf of OCL to OCL's overseas banks.

4.16 OCL paid interest to ORPL, which in turn paid interest to the banks from which it borrowed.

4.17 During the life of a loan, ORPL would review any requests by a borrower for amendment or waiver of terms of a loan agreement. ORPL would inform OCL in the Cayman Islands of the request and make a recommendation; no such request would be agreed to until OCL's board in the Cayman Islands had confirmed its approval, which OCL's board invariably did.

4.18 The cash resources of OCL were invested by ORPL which: (1) placed funds through its treasury unit in the money markets or (2) used them for its own purposes or (3) funded OCL's loan portfolio. Funds placed with ORPL's treasury unit would earn interest at the market rate. OCL's capital and reserves and the funding (that is, deposits) it took from ORPL and subsequently from the Singapore branch of RBC during the years in question are reflected in the following year-end figures (in USD 000's):

Balance Sheet Date	Capital	Dividends	Retained Profit	Amount Due To ORPL	Amount Due To RBC
31-12-80	5,977	-	425	84,428	-
30-9-81	5,977	-	2,310	93,996	-
30-9-82	5,977	-	4,472	100,783	-
30-9-83	5,977	4,115	2,314	109,749	-
30-9-84	5,977	-	4,480	135,538	-
30-9-85	5,977	-	6,688	81,107	51,842
30-9-86	5,977	-	8,621	-	115,271

At the 1982 and 1983 year ends, the 'Amount due to ORPL' includes in each case a balance sheet item 'Current and Deposit Accounts'. As for 1983, we are satisfied on the evidence that the item consisted of short-term deposits placed with OCL by ORPL; although there was no evidence offered in respect of the figures at 30th September, 1982, we are inclined to the view that the

same was true of the item in the balance sheet as at that year end, and we so find.

4.19 There are three distinct periods in the funding transactions of OCL: (1) until August, 1983 it was funded by ORPL's treasury unit; (2) in August, 1983 ORPL's treasury unit was absorbed by the Hong Kong branch office of RBC, and thereafter ORPL acted as a conduit, taking funds from RBC and on-lending them to OCL at the same rate; and (3) in late August, 1985 ORPL ceased to act as a conduit, and OCL took funding directly from the Singapore branch of RBC. We find that throughout the three periods, ORPL conducted all the funding transactions on behalf and in the name of OCL. ORPL went into voluntary liquidation in September, 1987. OCL went into voluntary liquidation on 23rd September, 1987.

4.20 From the records produced on behalf of OCL to illustrate the funding transactions, we find as follows:-

4.20.1 The agent of a syndicated loan would advise OCL that the borrower had given notice of a drawdown or rollover on a certain date. In three out of the seven examples given, the telex which conveyed the advice could not be located. In one example, the agent communicated with both OCL in the Cayman Islands and ORPL in Hong Kong, while in the other three, the agent in each case notified OCL care of ORPL in Hong Kong. We find that in the majority of cases the agent communicated with OCL care of ORPL in Hong Kong. The rate of interest for the drawdown or rollover was set by the agent at a rate over a basis rate which would be LIBOR (London Inter-Bank Offered Rate) in the case of a US$ loan. The rate of interest was advised to OCL care of ORPL in Hong Kong by telex either together with the drawdown/rollover notice or separately.

4.20.2 The loans administration unit of ORPL, acting on behalf of OCL, would give notice to the treasury unit of ORPL (by means of a takedown (that is, drawdown) ticket or a renewal of loan (that is, rollover) ticket as the case might be) that OCL would require funds to meet the drawdown or rollover, giving the particulars of the loan including the desired spread (that is, margin over, say, LIBOR).

4.20.3 The treasury unit of ORPL would find the funds in the international money markets or from the fungible funds in its account and offer to place a deposit of the required amount at,

say, LIBOR with OCL, and the loans administration unit would accept the deposit on behalf of OCL. The treasury unit would raise a 'new time deposit-placed' ticket recording the placing of the deposit, whilst the loans administration unit would raise a 'new time deposit-accepted' ticket recording the acceptance of the deposit. If the treasury unit could find the funds at a rate lower than the deposit rate, ORPL would earn the difference, while OCL would earn any margin over the deposit rate.

4.20.4 Then there would be an exchange of confirmations between ORPL and OCL in Hong Kong. In its confirmation ORPL would confirm 'having placed with you the following deposit', specifying the particulars, and would state: 'The US dollars will be paid to your account at (naming OCL's banker), New York. At maturity pay the US dollars to our account at (naming ORPL's banker), New York.' Deutschemark and Yen transactions would be similarly handled through Frankfurt and Tokyo respectively. The confirmations were addressed to OCL care of ORPL in Hong Kong. In its confirmation OCL confirmed 'having accepted from you the following deposit', specifying the particulars, and stated the manner of payment and repayment in a similar way. The confirmation was prepared by ORPL and made in the name of OCL at the offices of ORPL. (After late August, 1985 OCL made deposit-taking contracts with the Singapore branch of RBC instead of ORPL. There was a similar exchange of confirmations between the Singapore branch of RBC in Singapore and OCL in Hong Kong, care of ORPL. As a matter of inference, we find that the contracts were made by ORPL on behalf of and in the name of OCL).

4.20.5 In the case of a drawdown, ORPL would send a tested telex to its bank in New York in the case of US dollars, instructing it to pay the funds to OCL's bank account in New York. Similarly, a tested telex would be sent by ORPL on behalf of OCL to OCL's bank in New York instructing it to pay the drawdown amount to the agent's bank account.

4.20.6 In the case of a rollover with no partial repayment, ORPL would send a tested telex to its bank instructing it to pay the new funds to OCL's bank account. A tested telex would be sent by ORPL on behalf of OCL to OCL's bank instructing it to pay the maturing funding plus interest to ORPL's bank account. OCL received

interest from the agent and used it largely to meet the interest due to ORPL.

4.20.7 Repayments and partial repayments made by the agent to OCL were paid over to ORPL with the interest due.

4.20.8 The agent would also pay OCL the commitment fee and its share of the front end fees in respect of each loan.

4.20.9 OCL deposited surplus cash with ORPL from time to time. In such cases, their roles were reversed and there was a similar exchange of confirmations.

4.21 OCL normally had three directors, with one director resident in each of the Cayman Islands, Hong Kong and the United Kingdom. OCL and ORPL shared common directors. OCL's directors were not remunerated directly by OCL, but by the group company or companies which provided them and were paid by OCL for providing their services. OCL employed no staff in the Cayman Islands; any clerical or secretarial facilities required there were provided by RoyWest at a fee.

4.22 The board of directors of OCL held its meetings in the Cayman Islands. Its main business was to consider and approve loan participations recommended by ORPL, and its main duty was to see that the proposal would not infringe the laws of the Cayman Islands. As for the merits of the loan, the board relied on the evaluations of the loan or credit committees of the group and approved all the recommended loans except on the one occasion mentioned in 4.12 above. Although the loan approvals were a formality in nature, they did in our view involve a decision making process, so that the board was not a mere rubber stamp in approving the loans. It had the power to disapprove them. Once a loan was approved and the loan agreement signed, the ensuing business of borrowing and on-lending was entrusted entirely to ORPL, which took deposits on behalf of and in the name of OCL up to late August, 1985 from itself and subsequently from the Singapore branch of RBC. It did this without seeking or having to seek prior approval or subsequent ratification from OCL in the Cayman Islands.

4.23 The service agreement dated 18th October, 1979 (see 4.6.1 above) was carried out in some aspects but not in others. Clause 1 was carried out: (1) OCL's participation in the loans was administered by ORPL; the borrowers' requests for drawdown and rollovers, the repayments and payments of interest were channelled through the agent to OCL care of ORPL in Hong Kong; there is some question as to whether the funding provided by ORPL through the

placement of deposits came under the service agreement; (2) OCL's bank accounts in New York and other financial centres were operated by ORPL; OCL's banks communicated with OCL care of ORPL in Hong Kong. (3) All accounting facilities were provided to OCL by ORPL in Hong Kong; OCL's accounts were prepared by ORPL and audited in Hong Kong, and were then sent to the Cayman Islands office of the auditors for the audit to be completed in accordance with the local laws. Clause 2(a) was carried out, in particular relating to the investment of OCL's capital and reserves. So was clause 2(b). There was no performance of clause 2(c) or (d), nor did OCL's board in the Cayman Islands exercise their rights under those provisions by calling for any quarterly report, statistical or other information on the business and affairs of OCL, or on its loan and investment portfolios. Clause 4 will be dealt with later (see 10.3.4 below). Clauses 5 and 6(a) were carried out, except that the computation of the remuneration for ORPL was revised by an agreement dated 1st October, 1985 to 0.1% of OCL's average loan portfolio during the year. Clause 7 entitled either party to terminate the service agreement by giving the required notice; the service agreement in fact remained in force throughout the years in question."

The board also found as a fact (at the request of the taxpayer) that the taxpayer was not registered in Hong Kong (as an oversea company) under part XI of the Hong Kong Companies Ordinance, Cap.32, and that the taxpayer was a participant or member of a number of syndicates. The board further found as a fact (at the request of the Commissioner) that at all relevant times, in particular from late August 1985 to 1 September 1986, the Royal Bank of Canada ("RBC") had a licence under the Banking Ordinance, Cap.155, to operate a branch in Hong Kong.

The law

The broad guiding principle which must be applied to the facts of any case in order to decide where a profit arises is simply stated as follows : one must look to see what the taxpayer has done to earn the profit in question and where it has done it (see *CIR v. Hang Seng Bank Ltd* [1991] 1 AC 306, especially per Lord Bridge of Harwich at p.323; and *CIR v. HK - TVB International Ltd* [1992] 2 AC 397, especially per Lord Jauncey of Tullichettle, at p.407). The distinction which falls to be made between profits arising in or derived from Hong Kong and profits arising in or derived from a place outside Hong Kong must be made according to the nature of the different transactions by which the profits are generated (see the *Hang Seng Bank* case, at p.319B). One must look to "the gross profits accruing from individual transactions" (see the *Hang Seng Bank* case, at p.322A). The question whether the gross profit resulting from a particular transaction arose in or is derived from one place or another is always, in the last analysis, a question of fact, depending on the nature of the transaction (see the *Hang Seng Bank* case, at p.322H).

The board's conclusion

The board of review, applying these principles to the facts of the instant case, concluded that "the profit which was contained in the interest receipts will have arisen in or derived from New York, Tokyo or Frankfurt, as the case may be, *as the place where the money was lent*" (emphasis added) : see paragraph 10.6 of the stated case. We cannot interfere with this conclusion unless we are of the opinion that the true and only reasonable conclusion would have been that the relevant profits arose in or were derived from in Hong Kong : see *Edwards v. Bairstow* [1956] AC 14, especially per Lord Radcliffe at pp.35, 36.

In following the broad guiding principle in the instant case, the board looked to the places where the money was lent. In doing so, it had in mind the observation, given by way of example, in the *Hang Seng Bank* case at p.323B, to the effect that, where a profit is earned by lending money, the profit will have arisen in or derived from the place where the money was lent. It concluded that what the taxpayer had done here to earn the profits in question was to lend money, and that it did that offshore. In our judgment, not only was the board entitled so to find; no other conclusion would have been open to it.

Neither the *Hang Seng Bank* case, nor the present case, provides more than an example of the application of the broad guiding principle. In some factual situations, it will be appropriate to describe what the taxpayer has done to earn the profit in question as the effecting of a transaction; the *Hang Seng Bank* case, and the present case, are examples. In others, it may be more appropriate to describe what the taxpayer has done to earn the profit in question as the performance of an operation : the *HK - TVB International* case is an example. The common factor is that, in every case, one must look to the nature of the transaction (or operation, or activity) which generates the profit; one must then look to see where that transaction was effected (or that operation performed, or that activity carried on). Whether what is sought to be charged to tax is appropriately to be described as the profit from a transaction, an operation or an activity will vary according to the facts of the particular case. There is no conflict between the *Hang Seng Bank* case and the *HK - TVB International* case. In the former case, the source of the profits in question was held to be the series of transactions effected by the taxpayer offshore. In the latter case, the source was held to be the operation carried on by the taxpayer in Hong Kong. It is not a matter for surprise that the decision in the latter case, on quite different facts, favoured a Hong Kong rather than an offshore source.

The first issue

In the present case, then, the conclusion reached by the board of review on the first issue, that what the taxpayer did to earn the profits in question it did in New York, Tokyo and Frankfurt, the various places where the money was lent, was a conclusion to which, on the facts, the board was entitled to come. It follows that the board's conclusion betrays no error of law. Further, it is consistent with the legislature's view of the matter;

for s.15(1)(i) of the Ordinance makes sense only on the footing that the transaction which generates the profit, in the case of an offshore loan, is the making available of the money from which the interest arises. In our case this happened, not in Hong Kong, but in New York, Tokyo or Frankfurt. This supports the board's conclusion.

The second issue

But if, at the material time, the taxpayer was a "financial institution", the receipts of the taxpayer derived from these transactions cannot escape the charge to tax imposed by s.14 merely because they arose from transactions effected in New York, Tokyo and Frankfurt. Section 15(1)(i) brings the receipts within that charge.

The expression "financial institution", defined in s.2 of the Ordinance, included an associated corporation of (i) a licensed bank or (ii) a registered deposit-taking company or (iii) a licensed deposit-taking company, which, being exempt by virtue of s.3(2)(a), (b) or (ba) of the Deposit-Taking Companies Ordinance ("DTCO"), would have been liable to be registered or licensed as a deposit-taking company under the DTCO had it not been so exempt. The relevant question is whether, but for an applicable exemption, the taxpayer here would have been liable to be so registered or licensed. The question admits of a short answer.

The DTCO was enacted (see the preamble) to regulate deposit-taking businesses for monetary policy purposes; to regulate the taking of money on deposit; and to make provision for the protection of persons who deposit money. This must mean persons who deposit money in Hong Kong. There is nothing in the DTCO to suggest that it was intended to have extra-territorial effect. The board concluded that the taxpayer was a company which, but for the applicable exemptions, "would have been liable to be registered or licensed" under the DTCO and so was a "financial institution" within the meaning of s.15(1)(i). But that cannot be right. The taxpayer took no deposits in Hong Kong, and, on the facts found by the board, cannot be said to have been carrying on the business of taking deposits in Hong Kong. It did carry on in Hong Kong a business which included the taking of deposits, but that is irrelevant. The board found as a fact that all deposits placed with the taxpayer were placed by ORPL and that the deposits, like the loans, were all made in New York, Tokyo or Frankfurt. The board's determination, in these circumstances, that the taxpayer carried on the business of taking deposits in Hong Kong contradicts its findings of fact and accordingly betrays an error of law which we are entitled and bound to correct. The taxpayer did not carry on such a business and so was not a "financial institution" to which s.15(1)(i) applied.

It follows, as a matter of law, that s.15(1)(i) does not bite on the profits in question, and that those profits are accordingly not brought into the charge to profits tax imposed by s.14.

Conclusion

The taxpayer therefore succeeds in its appeal against the decision of the board (which favoured the Commissioner) in relation to s.15(1)(i), and the Commissioner fails in his appeal against the decision of the board (which favoured the taxpayer) in relation to s.14. In fine, the taxpayer escapes profits tax altogether in respect of the profits in question. The costs of the taxpayer of these appeals must be taxed and paid by the Commissioner to the taxpayer.

(G.M. Godfrey)	(Charles Ching)	(D.J. Leonard)
Justice of Appeal	Justice of Appeal	Judge of the High Court

Mr. Robert Ribeiro, Q.C. & Mr. Gordon Fisher (M/s. Johnson Stokes & Master) for Appellant

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