HCIA 1/2003

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE

INLAND REVENUE APPEAL NO. 1 OF 2003

BETWEEN

Baring Securities (Hong Kong) Limited, presently known as
ING Baring Securities (Hong Kong) Limited Appellant

and

The Commissioner of Inland Revenue Respondent

Before: Hon Barma J in Court
Dates of Hearing: 6-11 October 2003
Date of Judgment: 1 June 2005

J U D G M E N T

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1. This is an appeal by way of case stated, brought by the taxpayer, ING Barings Securities (Hong Kong) Limited ("BSHK") against the decision of an Inland Revenue Board of Review ("the Board") dated 8 February 2002, pursuant to section 69 of the Inland Revenue Ordinance (Cap. 112) ("the Ordinance").

2. BSHK is a wholly owned subsidiary of the Barings Bank group, whose collapse in the mid-1990s and subsequent take over by the ING group of companies is well-known. The present appeal concerns a period before that collapse. At that time, BSHK was part of a sub-group of companies within the Barings Bank group headed by Barings Securities Ltd ("BSL"). The business of that sub-group was the undertaking, on behalf of clients of the companies forming part of it, of trading of securities listed on stock markets around the world. This was known as the "agency brokerage" business.

3. The hearing before the Board involved an appeal by BSHK against a determination of the Commissioner of Inland Revenue ("the Commissioner") dated 31 July 1997 by which the Commissioner:

(1) confirmed Profits Tax Assessments in respect of BSHK's profits for the years of assessment 1990/91, 1991/92, and 1993/94;

(2) confirmed an Additional Profits Tax Assessment in respect of BSHK's profits for the year of assessment 1990/91;

(3) increased the Profits Tax Assessment in respect of BSHK's profits for the year of assessment 1992/93; and

(4) reduced the Profits Tax Assessment in respect of BSHK's profits for the year of assessment 1994/95.

4. BSHK had objected to the assessments on the basis that a part of its income for the years of assessment in question fell outside the scope of the charge to profits tax imposed by section 14 of the Ordinance, primarily because (according to BSHK) those profits arose or were derived from outside Hong Kong, and so were not chargeable to Hong Kong profits tax, as they were derived from the execution of trades in securities listed on stock markets outside Hong Kong.

5. For the purposes of the hearing before the Board, the parties agreed a Statement of Agreed Facts, the first five paragraphs of which set out certain agreed background information concerning BSHK and also set out the agreed amounts of the income the chargeability of which was disputed (thus relieving the Board of having to make any findings as to quantum in respect of the income concerned). These parts of the Statement of Agreed Facts were substantially reproduced in paragraphs 6 to 10 of the Stated Case on which this appeal was based, and, so far as material for present purposes, can be summarised as follows:

(1) BSHK was incorporated in Hong Kong on 24 April 1984, and was a member of the Barings group of companies, the majority of which (including BSHK) were acquired by Internationale Nederlanden Groep NV ("ING") on 8 March

1995. The takeover of BSHK by ING did not bear on the facts of the appeal or the Board's decision.

(2) BSHK was part of a sub-group, within the Barings group of companies, which dealt in securities globally. The main holding company of this sub-group was BSL. The corporate structure of this sub-group was depicted in a chart which was put in evidence by one of BSHK's witnesses at the Board hearing, and which was annexed as Appendix A to the Board's decision.

(3) BSHK was registered in Hong Kong as a dealer under the Securities Ordinance, and its principal activity was to act as an agent in securities dealing.

(4) In its Profits Tax returns for the years of assessment 1990/91 to 1994/95, BSHK claimed that some of its income was derived from or arose outside Hong Kong. The figures in the first three of these returns were the subject of later revision by BSHK. The final figures provided to the Inland Revenue Department (all in Hong Kong dollars) were as follows:

(a)	Year of assessment 1990/91:	
	(i) Revised profits offered for assessment	4,259,368
	(ii) Revised offshore income	70,985,000
	(iii) Offshore sub-underwriting commission	156,379
(b)	Year of assessment 1991/92:	
	(i) Revised profits offered for assessment	22,317,988
	(ii) Revised offshore income	60,465,000
(c)	Year of assessment 1992/93:	
	(i) Revised profits offered for assessment	74,775,178
	(ii) Revised offshore income	68,054,000
	(iii) Other offshore income	6,841,946
(d)	Year of assessment 1993/94:	
	(i) Profits offered for assessment	127.438,074
	(ii) Offshore income	40,351,435
(e)	Year of assessment 1994/95:	
	(i) Profits offered for assessment	27,678,658
	(ii) Offshore income	25,255,605

6. By the time the matter came before the Commissioner, the assessor was contending that all of the items described as being "offshore" were chargeable to Hong Kong profits tax, and

the effect of the Commissioner' s determination was to agree with this contention. However, when the matter was before the Board, and at the hearing before me, the items described as "offshore sub-underwriting commission" in the revised return for the 1990/91 year of assessment and as "other offshore income" in the revised return for the 1992/93 year of assessment, were not addressed in argument. I therefore do not deal with them in this judgment, and the assessments and determination in relation to them will therefore stand, regardless of the outcome of this appeal.

7. Returning to the Statement of Agreed Facts, it was further agreed in relation to the offshore income in dispute that this was arrived at as follows:

	1990/91 $000s	**1991/92 $000s**	**1992/93 $000s**	**1993/94 $000s**	**1994/95 $000s**
Placements	26.086	2.540	8.994	1.574	---
Commission	17.551	12.986	33.480	129.180	118.450
Marketing	86.986	80.745	69.782	27.012	91.200
Commission waivers	---	---	(1.659)	(1.421)	---
	130.623	96.271	110.597	156.345	209.650
Expenses	(59.638)	(35.806)	(42.543)	(114.850)	(184.678)
	70.985	60.465	68.054	41.495	24.972
Adjustments for expenses, depn. and rebuilding allowances	---	---	---	(1.143)	284
Offshore incomes	70.985	60.465	68.054	40.351	25.256

8. It will thus be seen that the disputed income was divided into three broad categories - "placements", "commission" and "marketing" income. Although there was a fourth item, described as "commission waivers" this was, in both of the years of assessment in which it appeared, a negative figure, so that it went to reduce the gross income which was said to be offshore income for that year.

9. The Statement of Agreed Facts also included a number of appendices, among which were a set of appendices (B to B4) which provided a country by country breakdown of the amounts of such placement, commission and marketing income, by reference to the country on whose stock markets trading had given rise to such income in each year of assessment.

10. Essentially, in respect of each year of assessment, BSHK offered up for assessment its profits derived from the execution of trades in securities on behalf of clients of the BSL sub-group on exchanges located in Hong Kong, regardless of the location of the client in question, and the country from which instructions to execute such trades came. On the other hand, all profits which BSHK derived from trades in securities on behalf of clients of the BSL sub-group on

exchanges outside Hong Kong were excluded, even if the client was located in Hong Kong, or instructions to execute such trades were given to BSHK in Hong Kong.

11. At the hearing before the Board, the evidence consisted of correspondence between BSHK, BSL and BSHK's tax representatives and the Inland Revenue Department, BSHK's profits tax returns for the relevant years of assessment, sample documentation in respect of the execution and settlement of client trades for each of the seven countries on whose stock markets securities were traded from which the disputed income arose, and a number of agreements for commission sharing (which were relevant to the income described as "marketing" income). In addition, BSHK adduced evidence from three witnesses - Mr Ramsay Urquhart, Mr Patrick Lawlor and Mr Paul Snead, each of whom provided witness statements and gave oral evidence at the hearing.

12. According to the Stated Case, having considered the evidence, the board made the findings of fact set out in paragraphs 13 to 21 of that document. These can be summarised as follows:

(1) BSL was one of the principal subsidiaries of Baring Brothers & Company Limited, which was at the head of the BSL sub-group. With the exception of one sub-subsidiary in Indonesia, PT Baring Securities Indonesia which was ultimately owned as to 80% by BSL and 20% by a local partner, all of the sub-subsidiaries in the Asia Pacific region which figure in this appeal were ultimately wholly-owned by BSL.

(2) BSHK was acquired so as to become part of the BSL sub-group in 1986. At that time, the BSL sub-group traded in the Hong Kong and Japanese equity markets. BSHK obtained a licence to deal in securities in Hong Kong in about 1988 or 1989. During the period with which this appeal is concerned, licences were acquired by subsidiaries in other countries enabling them to trade on the Manila, Singapore and Jakarta stock exchanges.

(3) The BSL sub-group's business was that of "agency brokerage", consisting of the execution of client trades on securities listed on major global stock exchanges.

(4) This business could be functionally divided into three principal divisions (apart from Administration) - Research and Sales, Execution and Settlement.

(5) Research and Sales were regarded as important parts of the business, which attracted and obtained business from institutional clients and fund managers which formed the bulk of the sub-group's clientele. The quality of research provided to such clients was a major factor in attracting their custom, and the

BSL sub-group ranked very highly in respect of research on Asian securities markets. Research was undertaken by analysts based in the markets on which the securities which were the subject of such research was traded. Research publications were edited in London and printed in Singapore, and were distributed to clients by the sales department or sales desk of the various subsidiaries. The sales desk of the various subsidiaries received client orders for trading in securities and liaised with the clients regarding such orders. In general, sales desks in the various companies took orders from clients located in the country in which they operated, and passed on such orders through the chain of companies in the sub-group to the execution office.

(6) The execution office was the office of the sub-group company in the execution location, and was the company which actually executed the client trade, if it was licensed to operate on the local stock exchange. Where the sub-group company in the execution location did not have the requisite licence, execution would be carried out by a third party licensed dealer employed for this purpose. At the beginning of the period with which this appeal is concerned, the only locations in which sub-group companies had a licence to deal in securities were Hong Kong and Japan, but licences were obtained in the Philippines in late 1990, Indonesia in 1991 and Singapore in 1992. It was not clear whether licences were ever obtained to trade on stock markets in Korea and Taiwan.

(7) The settlements division dealt with confirmation of the client trade to the client, banking arrangements, custody of shares, delivery of shares. This was generally regarded as the least important of the three divisions, its location being determined by the location of the stock exchange on which the client trade was executed.

(8) The Board observed that it did not have before it documentation which demonstrated the contractual relationship between a client and a particular sales desk, as the documentation started with the documentation generated once an order had been received. Subject to that, the Board found that the workflow in respect of a particular transaction commenced when the sales desk, having received the order from the client, passed the order on to BSHK and/or the sub-group company in the execution location, and that this occurred either by orders being passed to BSHK which in turn passed them on to the sub-group company in the execution location, or by orders being sent simultaneously to BSHK and the sub-group company in the execution location. The relevant sub-group company in the execution location would then attend to the execution of the client trade, either itself (if licensed) or through a third party (if it was not).

(9) The Board then went on to state that it found that there was a material difference between the "commission" and "marketing" income, and that it was satisfied that the offshore profits of BSHK were not profits of other group companies which were booked or re-invoiced to BSHK.

(10) Finally the board indicated that it had found that the role of BSHK went beyond that of what it described as a mere "booking" role, describing BSHK as something of a regional office of the sub-group in the Asia Pacific region, playing a role in the forwarding of client orders from the sales desks where they were received to the execution office, housing some of the back office computer equipment, and having varying degrees of involvement in the execution of trades in foreign securities.

13. Having stated that it had made these findings, the Board then noted that it had dismissed BSHK's appeal on the ground that BSHK had not discharged its burden of proof (imposed by section 68(4) of the Ordinance) of demonstrating that the assessments were incorrect, having regard to what the Board considered to have been:

(1) the inability or failure to clearly categorise the different types of income and the aggregation of the marketing and commission income in BSHK's evidence and submissions;

(2) the imprecise and general nature of the evidence tendered to it; and

(3) BSHK's inability to relate the evidence adduced to its accounts and the figures for the income under dispute.

14. The Stated Case also contained a number of annexures. These consisted of the entire decision of the Board, the Statement of Agreed Facts, the witness statements of the witnesses called by BSHK, a document (known as the TREBOR report) prepared in about February 1994 which recorded the workflow within the BSL sub-group in respect of orders for the purchase or sale of securities on the various markets which contributed to the income which was the subject matter of the appeal to the Board, certain pre-determination correspondence from Coopers & Lybrand and BSL to the Revenue, BSHK's 1993/94 tax computation and substantially the whole of the transcripts of the evidence of the witnesses at the hearing before the Board.

15. The questions of law posed by the Board in the Stated Case were as follows:

"(1) Whether the Board of Review erred in law by failing to apply the correct principles of law and, in particular, by failing to address the correctness or otherwise of the assessments by reference to the 3 conditions (as was

explained in *CIR v Hang Seng Bank Limited* [1991] 1 AC 306 at 318E-F) that must be satisfied before a charge to profits tax can arise?"

"(2) Whether on the facts as found by the Board of Review, the Board of Review erred in law in failing to conclude that the off-shore profits concerned were not earned by activities undertaken in Hong Kong by [BSHK]?"

"(3) Whether upon the evidence before the Board of Review and in all the circumstances of the case the Board erred in law by making the following findings of fact:

(a) The findings [set out in paragraph 18 of the Stated Case] as to the passage of client orders through [BSHK].

(b) The findings [set out in paragraph 19 of the Stated Case] that there was a material difference between the income described in the Board's Decision as "commission income" and the income described in the Board's Decision as "marketing income".

(c) The findings [set out in paragraph 20 of the Stated Case] that the offshore profits were not profits of other Group companies which were "booked" or "re-invoiced" to [BSHK].

(d) The findings [set out in paragraph 21 of the Stated Case] concerning the role of [BSHK] in group trading in the Asia Pacific region/time zone."

16. At the hearing before me, on the application of BSHK, I permitted the framing of one additional question of law, which I would deal with if it were possible to answer it on the basis of the materials annexed to the Stated Case, as BSHK did not wish to contend that the rest of the materials which were before the Board should be put before me. This question was in the following terms:

"(4) Whether upon the evidence before the Board of Review and in all the circumstances of the case, the Board of Review erred in law in deciding that [BSHK] had failed to discharge the burden of proving the assessments to be incorrect or excessive, when at the hearing of the appeal, some 19 months earlier, [BSHK] had called witnesses whose credibility was not impugned and produced contemporaneous documents (including sample documentation for the trading concerned) whose authenticity was not challenged, which prima facie established that:

(a) all the profits concerned arose from securities trading or related trading on Stock Exchanges outside Hong Kong ([BSHK] not having objected to those parts of the assessments relating to securities trading (etc.) Which had been undertaken in Hong Kong) by other [BSL] sub-group companies operating in jurisdictions where [BSHK] had no presence;

(b) two-thirds of the securities trading orders concerned originated in the U.S.A. or Europe from customers of other [BSL] sub-group companies operating in those jurisdictions where [BSHK] had no presence;

(c) the other one-third of the orders originated from the many other jurisdictions where the [BSL] sub-group of companies operated, including Hong Kong;

(d) the research and sales activities which primarily generated the orders concerned were undertaken in the foreign jurisdiction where the securities were traded; and

(e) the settlements of the executed securities trades were performed in the foreign jurisdiction of execution.

- i.e., prima facie evidence that all or most of the activities that produced the off-shore profits took place outside Hong Kong."

17. Although he had applied for Question 4 to be added to the questions of law posed by the Stated Case, Mr Barlow, appearing for BSHK, indicated in his closing submissions that in the light of the arguments addressed to me, this question had become of considerably less significance for the purposes of BSHK' s appeal. As will become apparent below, this is a view which I share, and in the result, I do not think it necessary to deal with Question 4.

18. It will be convenient to deal first with Question 2. Mr Barlow submitted that the Board misunderstood the principles which are to be applied when determining whether or not a taxpayer' s profits arise in or derive from Hong Kong, or have a Hong Kong "source" in a territorial sense. He submitted first that the Board erred in focussing too closely on the acts of BSHK, and that it should have sought to identify the operations (whether of BSHK or some other entity) which gave rise to the profits which BSHK claimed to arise offshore Hong Kong, saying that to focus on BSHK was to misunderstand the authorities from which the test was derived. Alternatively, if that was wrong, and it was necessary to consider what were the operations of BSHK that gave rise in substance to the profits under consideration, Mr Barlow submitted that it the relevant operations consisted (in the case of the commission and placement income) of BSHK allowing itself to be interposed as a counter-party in the execution location, between the client on the one hand and the execution office on the other, for the facilitation of the provision of the agency brokerage services of

the BSL sub-group to the sub-groups clients around the world. He also submitted that having regard to this interposition of BSHK, it also followed that the execution office should be regarded as executing the relevant trades as agent for BSHK, since from the execution office's point of view, its immediate client was BSHK rather than the sub-group's ultimate client. While the operations involved in the provision of the service of facilitating the sale or purchase of securities on various stock exchanges around the world were performed in various locations - that of the sales desk which took the order from the external client of the sub-group, that of the execution office and that where settlement took place (generally the same as that of the execution office), the operations primarily took place in the execution location.

19. For her part, Ms Li S.C., appearing for the Commissioner contended that it was necessary to focus on the operations of BSHK itself, and submitted that it was entirely open to the Board to have come to the conclusion that BSHK had not discharged the burden of showing that the assessments were wrong or excessive, as the Board was left uncertain as to what precisely BSHK had done, in terms of its operations, to earn the profits in question. Ms Li drew attention to the fact that despite requests from the Revenue, BSHK and its advisers did not appear ever to have provided an organisation chart in respect of itself, which might have thrown light on its internal organisation and on the staff employed by it, and the functions which they performed.

20. I shall deal first with the applicable legal principles, and then go on to consider how they apply in this case to each of the three types of income under consideration.

21. The starting point, so far as the legal principles are concerned, is section 14 of the Ordinance. Section 14(1) provides as follows:

> "(1) 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."

22. As Lord Bridge pointed out in *Commissioner of Inland Revenue v Hang Seng Bank Limited* [1991] 1 AC 306 (at p.318E-G):

> "Three conditions must be satisfied before a charge to tax can arise under section 14: (1) the taxpayer must carry on a trade, profession or business in Hong Kong; (2) the profits to be charged must be "from such trade, profession or business," which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong; (3) the profits must be "profits arising in or derived from" Hong Kong. Thus the structure of the section presupposes that the profits of a

> business carried on in Hong Kong may accrue from different sources, some located within Hong Kong, others overseas. The former are taxable, the latter are not."

23. Lord Bridge went on to say (at p.322H-323B), in relation to the question of where particular profits arose in or were derived from:

> "But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested to by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected."

24. In the later case of *Commissioner of Inland Revenue v HK-TVB International Limited* [1992] 2 AC 397, Lord Jauncey, delivering the judgment of the Privy Council, said this at p.407C-D:

> "... *F.L. Smidth & Co. v Greenwood* [1921] 3 KB 583 was cited in the *Hang Seng Bank* case and their Lordships do not doubt that Lord Bridge had in mind the judgment of Atkin LJ in that case and in particular the passage when he said, at p.593: ' I think that the question is, where do the operations take place from which the profits in substance arise?'
>
> "Thus, Lord Bridge' s guiding principle could properly be expanded to read ' one looks to see what the taxpayer has done to earn the profit in question and where he has done it.' ..."

25. In my view, both of these authorities direct one to a consideration of the operations of the taxpayer which produce the profits the chargeability of which is in question. Both Lord Bridge and Lord Jauncey refer clearly to the acts or operations of the taxpayer as being the relevant criteria.

26. Mr Barlow suggested, however, that that the genesis of the test so formulated, i.e. the statement of Atkin LJ in *Smidth v Greenwood*, was couched in less personal terms, and that there

were other passages in the judgment of Lord Jauncey in the *HKTVB International* case which were in similarly less personal terms, such as the passage at p.407F, where he said:

> "... it is clear that the first question to be determined in this appeal is what were the transactions which produced the profit to the taxpayer."

and a later passage at p.409E, where he said:

> "The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place."

27. In my view, this submission is not well founded. It is clear from the judgment of Lord Jauncey, read as a whole, that he was throughout posing the question in terms of the operations of the taxpayer which produced the profits in question, rather than in terms of operations in a more general sense, not necessarily those undertaken by the taxpayer. This is, I think, apparent from the sentence immediately following that at p.409E of the judgment referred to above, where Lord Jauncey went on to say:

> "Adopting this approach what emergies is that the taxpayer, a Hong Kong based company, carrying on business in Hong Kong, having acquired films and rights of exhibition thereof, exploited those rights by granting sub-licences to overseas customers. The relevant business of the taxpayer was the exploitation of film rights exercisable overseas and it was a business carried on in Hong Kong."

Moreover, the matter is, I think, put beyond doubt by the passage at p.411B of the judgment, where Lord Jauncey identifies the error by the Court of Appeal in that case as follows:

> "In their Lordships' view the Court of Appeal failed to give proper consideration to the fundamental question of what were the operations of the *taxpayer* which produced the relevant profit"

(emphasis added).

28. Further, a consideration of the facts of *Smidth v Greenwood* indicates, to my mind, that although Atkin LJ may have spoken in terms less personal to the taxpayer, his formulation of the test should nonetheless be understood as directing the inquiry to the operations of the taxpayer, rather than the operations of others. In that case, the company whose profits it was sought to hold chargeable was a Danish company, based in Copenhagen, which manufactured cement-making and other machinery which they exported all over the world. They had an office in London staffed by a full time employee, an engineer who received enquiries for machinery, sent details to Denmark of what the machinery sought was needed for, and provided assistance to English buyers of such machinery in setting up such machinery for them when they had purchased it. It therefore appears

that all relevant acts were done by the Danish company, either through employees in Denmark or through the employee in England. No question therefore arose of the relevance of acts or operations of persons or entities other than the taxpayer, and Atkin LJ must have had in mind only the operations of the Danish company when posing the question in the terms which he did.

29. This conclusion is, I think, also supported by the decision of the Privy Council in *Commissioner of Inland Revenue v Orion Caribbean Limited* [1997] 2 HKC 449, in which it was held that it was relevant to consider the acts of the agents of the taxpayer as well as the acts of the taxpayer itself, since the acts of agents are, in law, those of the principal. Were it relevant to look at acts of other entities such as other companies in the same group that were not agents of the taxpayer, it would not seem to have been necessary for the court there to have found that the parent company of the taxpayer in that case acted as its agent in Hong Kong.

30. Finally, I should say that I do not accept the submission made by Mr Barlow that when dealing with the position of a group of companies, it is appropriate in this context to have regard to the group as a whole. Mr Barlow based this submission on *Overseas Containers (Finance) Ltd v Stoker (Inspector of Taxes)* [1989] STC 364. In my view, that case is authority only for the proposition that in considering whether or not a transaction has a commercial purpose, so as to amount to a trading transaction, it is relevant to consider the purpose of the transaction from the viewpoint of the group of companies to which the taxpayer belongs as a whole. The inquiry in that situation is as to the purpose of the transaction, whereas in the present case, the question is one of identifying the operations of the taxpayer which give rise to the profit or income the chargeability of which is being considered.

31. I therefore conclude that it is necessary to identify the operations of the taxpayer which in substance give rise to the profits under consideration. In the present case, it appears that the Board of Review concluded that on their findings of fact, it was not possible to conclude that such operations took place outside Hong Kong in respect of any of the three types of income which were the subject of the appeal before them.

32. I turn now to consider the correctness of that conclusion in relation to each of the three types of income that were under consideration.

33. I deal first with the "commission" income. It appears from the Case Stated and the Decision that the Board had some concerns about the relationship between the "commission" income and the "marketing" income. This appears to have arisen as a result of what the Board understood to be a submission by Mr Barlow to the effect that these two forms of income could be considered as being of the same general nature. The Board was not satisfied that this was the case, and concluded that there was a material difference between these two types of income.

34. As to this, it seems to me that what Mr Barlow was suggesting was that both these forms of income ultimately had their source in or derived from the commissions paid by clients of the

BSL sub-group. However, the basis on which, or route by which, such commissions found their way to BSHK so as to form part of its income was clearly different. In the case of the commission income, it was clearly explained by the witnesses that clients were, in most cases (in particular, in relation to trades in Singapore/Malaysia, Indonesia, the Philippines and Thailand) directed to pay commissions into bank accounts of BSHK in the execution location, along with the funds for the trade itself, where this was a purchase by the customer. The bank accounts were operated by the local BSL sub-group subsidiary in the execution location under powers of attorney, and out of the funds received, settlement would be made for the cost of the securities acquired, and payment would be made to the entity executing the trade (whether the BSL sub-group subsidiary or a local third party broker) of the commission due to it. There would remain an amount representing the difference between the commission payable by the client and the commission payable to the executing entity, which represented the commission income to BSHK. In relation to Japanese securities, the position was slightly different, in that the commission paid to Baring Securities Japan Ltd ("BSJ") was higher than the commission paid to BSHK, but some 40% of the commission paid to BSJ was subsequently rebated to BSHK, resulting in BSHK receiving a net commission on trades involving Japanese securities. It seems that the commission payable to BSJ was also sometimes reduced by the grouping together of client orders, resulting in a lower percentage commission being payable on larger aggregated trades. The position also appears to have been slightly different in respect of trades in Thai and Korean securities. In the former case, commissions were paid to Baring Securities Singapore Ltd ("BSS") which in turn paid 50% of its net commissions to BSHK as "marketing" income pursuant to agreements of the nature which I will describe when considering the "marketing" income below. In the latter case, it appears that BSL paid BSHK 50% of its income derived from commissions for trading in Korean securities under similar arrangements.

35. Although this flow of payments was not mentioned by the Board in its findings of fact referred to in the Case Stated, it does appear from the Decision, and in particular the table setting out the evidence in relation to the workflow in relation to the sample trade documents for the various countries where trading of securities gave rise to income for BSHK, and I am of the view that this is properly to be regarded as a finding of fact by the Board.

36. Moreover, it does not seem to me that there was a real dispute as to the nature of the commission income (or for that matter, the other forms of income under consideration). The focus of the argument was, I think, on the operations of BSHK which gave rise to such income.

37. As to this, it seems to me that the findings of fact made by the Board, particularly those mentioned in paragraphs 18, 20 and 21, do demonstrate that BSHK's main role in the agency brokerage business in respect of securities traded on the various markets in question was to allow itself to be interposed in such transactions between the ultimate clients and the execution office. The fact of such interposition would appear to be recognised by paragraphs 20 and 21, in which the Board in my view implicitly (and correctly) recognise that BSHK was the entity to which such trades were booked. The effect of this was that so far as the executing office was concerned,

its client was BSHK, and it acted as BSHK's agent in executing the trades on the local stock exchange in its country of operation.

38. If one is to identify a single transaction or set of transactions that in substance gives rise to the profits or "commission" income with which we are concerned, it seems to me that the obvious candidate is the actual execution of the trades in the relevant securities, on the relevant foreign stock exchange. That, after all, is the service that is provided in the course of the BSL sub-group's "agency brokerage" business. That is the service for which the client of the sub-group pays the commission which it is charged. Having regard to the position of the execution office as an agent of BSHK as explained in the previous sub-paragraph, it would seem to follow that the actual execution of the trades was carried out by BSHK through its agents outside Hong Kong.

39. I do not think that the position of sales is as critical, or that sales and research should be regarded as the operations from which the income or profits in substance arise. As I have noted, the service for which commission is paid is the effecting of executions of trades in securities. The commission is not, in my view, paid for the research which might have been provided to the client. Undoubtedly the research and sales functions are of importance in attracting business to the BSL sub-group. However, the business under consideration is that of agency brokerage. Given the nature of the clientele of the sub-group, consisting as it does principally of institutional investors and funds, the service provided is not so much advice as to what securities to purchase or sell as the facilitation of the purchase or sale of securities at the instance of the client. In this regard, the position here would appear to be clearly distinguishable from the situation in *Commissioner of Inland Revenue v Wardley Investment Services (Hong Kong) Ltd* 3 HKTC 703, in which the majority of the Court of Appeal took the view that the service provided by the taxpayer there consisted of the giving of investment advice in Hong Kong, and that payments received (or retained) arising from arrangements with overseas brokers whereby their services were provided on discounted terms were part of the agreed remuneration from the taxpayer's clients for the provision of that service.

40. Moreover, it seems to me that the real importance of sales and research is that it attracts business to the BSL sub-group in a general way. It brings in the clients. But that said, while it gives rise to the relationship with the client, it is the individual transaction that throws up the commission which gives rise to the income with which we are concerned.

41. I therefore do not consider that the Board was justified in concluding that the failure to produce documentation evidencing the relationship with the client, or the failure to provide a breakdown or details as to the amounts of income attributable to the countries or regions in which the clients were to be found, or from which the orders giving rise to the commissions originated, that BSHK had failed to discharge its onus of demonstrating that the assessment was incorrect or excessive. Even if I had been of the view that sales was a significant element, it does not appear that BSHK was involved in the obtaining of orders that originated outside Hong Kong, and it would therefore have been necessary to segregate only Hong Kong orders from the other orders giving

rise to the commission income with which we are concerned. Similarly, the failure to produce the organisation chart was, on this view of the facts, very much less significant.

42. Although the Board concluded that the role of BSHK was not one that was a purely booking or re-invoicing role, it seems to me that this does not detract from the need to identify the operation by BSHK which in substance gives rise to the income or profit. While there may well have been other functions that BSHK performed, it remains my view that the relevant operation in relation to the commission income was the execution of the trade in the relevant securities abroad. Alternatively, I would accept, as Mr Barlow put it in his closing submission, that the operation of BSHK giving rise to the income consisted in its permitting itself to be interposed between the client and the execution office, in order to facilitate the provision of the agency brokerage service. That interposition necessarily occurred, I think, in the execution location - the country in which the trade was executed.

43. At this juncture, I should perhaps mention that Mr Barlow also relied on the decision of the Privy Council in *Commissioner of Income Tax Bombay Presidency and Aden v Chunilal B Mehta of Bombay* (1938) 65 LR Indian Appeals 332 as support for the proposition that the relevant operations here took place abroad. In my view, the Board was justified in considering that this case was distinguishable from the present, since it was concerned with profits arising from proprietary trading in securities. As Lord Bridge pointed out in the passage from the *Hang Seng Bank* case which I have referred to in paragraph 23 above, there is a difference between profits earned from the provision of a service and those earned from the exploitation of assets. In the *Hang Seng Bank* and *Mehta* cases, the profits in question were earned from the exploitation of assets, whereas here, they were earned from the provision of a service by BSHK.

44. For the foregoing reasons, it seems to me that on the facts as found by the Board of Review, contrary to the Board's view, BSHK had established, on at least a prima facie basis, that the assessments were wrong or excessive so far as the commission income is concerned.

45. Turning to the income described as "placement" income, it seems to me that although the Board did not set out in the Stated Case any finding as to the nature of that income, there was no basis on which the Board could properly have rejected (if it did) the evidence of BSHK's witnesses as to the source of this income (which was not, in any event, seriously disputed - the question dividing the parties being again what, precisely, BSHK did in relation to this form of income). Having regard to that evidence, this income fell to be dealt with in the same way as the "commission" income, given the way in which it arose, namely as the net commission paid to BSHK in respect of the execution of orders for the acquisition of new issues of securities to be listed on stock markets outside Hong Kong, in respect of which BSHK permitted itself to be interposed between the client and the execution office in substantially the same way as it did in relation to "commission" income.

46. I am therefore of the view that on the facts as found by the Board, coupled with the finding which they were bound to arrive at as to the nature of the "placement" income, BSHK had also established, on at least a prima facie basis, that the assessments were wrong or excessive so far as the "placement" income is concerned.

47. I turn finally to consider the "marketing" income. The Board came to the view that this was different in nature from the "commission" income. I think that this conclusion was correct, notwithstanding that the ultimate source of this income, like the "commission" income, was the commission paid by the client for the execution of the client trade on the stock exchange concerned. I say this because whereas the "commission" income was paid to BSHK, and represented what was left of the commission after paying the execution office or broker in the execution location, the "marketing" income was, as explained by Mr Urquhart and Mr Snead, something which arose from various income sharing agreements which were entered into by BSHK with other BSL sub-group companies. A number of these agreements were put in evidence before the Board, and were described by it in its Decision. Two such agreements formed part of the appendices to the Stated Case. It is clear from the descriptions of the agreements, and from the two agreements which I have seen, that they provide for the payment of a proportion (generally 50%) of the commission earned by the paying party (described, somewhat confusingly, as the booking party) to the receiving party (described as the introducing party).

48. Unlike the "commission" income, the "marketing" income appears to have been received, not for the interposition of BSHK in the relevant trades, but (on the face of the agreements) for the introduction of custom to the executing office. The agreements therefore provided the means or opportunity for BSHK to derive further income from client trades of securities on stock exchanges outside Hong Kong. However, in order to earn such income, the agreements required BSHK to introduce business or clients to the execution offices concerned. There was a suggestion in the oral evidence given by the witnesses that this was not in fact necessary, and that marketing income was paid on the whole of the net commissions earned by the executing office. However, in the absence of some further evidence that this was in fact the case, it seems to me that the Board would have been entitled to take the view that an actual introduction of business was required.

49. The Board does not seem to have dealt specifically with the application of the test laid down by the authorities to this form of income. However, it seems to me that the operations of BSHK which in substance produced this "marketing" income would, in the light of the agreements which were in evidence, have been the introduction of customers to the execution offices concerned. The question is where this operation took place. Given that the introduction was to BSL subsidiaries in the execution location, for the purpose of executing trades of securities at that location, it seems to me that, on balance, the operation should be regarded as having taken place in the execution location. I therefore am of the view that this income, too, arose or was derived from outside Hong Kong, and therefore was not chargeable to profits tax under section 14 of the Ordinance.

50. For the foregoing reasons, I would answer Question 2 "Yes" in relation to each of the three types of income under consideration. It seems to me to follow that Question 1 (which is framed in very general terms) should also, in the circumstances, be answered the same way.

51. I would just add that it follows from the views that I have expressed that the Board was not justified in concluding that BSHK had failed to discharge the onus on it for the reasons given in paragraph 22 of the Stated Case. With respect to the Board, I do not think that the criticism in relation to the categorisation of the different types of income was justified. The nature of the incomes concerned were explained by the witnesses, and were not the subject of serious dispute. Nor do I think that the nature of the evidence was such as to prevent the Board from coming to the conclusions to which it should have come, having regard to the findings which it had, in my view, made. So far as the final criticism was concerned, it seems to me that, having regard to the volume of business involved, and the agreement as to the amounts of income falling within each of the categories concerned, this too, was not a valid criticism.

52. In the circumstances, I do not think it necessary to deal with Questions 3 and 4. So far as Question 3 is concerned, I would just observe that even if the findings referred to in that question were justified, they would not, for the reasons which I have given, resulted in a different answer to Questions 1 and 2.

53. The result is therefore, that the assessments for each of the years of assessment under consideration should be reduced so as to exclude from the assessable profits of BSHK the offshore income described as "commission", "placement" and "marketing income".

54. BSHK having succeeded in its appeal, I shall make an order *nisi* that the Commissioner should pay BSHK its costs of the appeal, to be taxed on the party and party basis if not agreed.

(Aarif Barma)
Judge of the Court of First Instance
High Court

Mr Barrie Barlow instructed by Messrs Kwok & Yih, for the Appellant

Miss Gladys Li, SC instructed by Department for Justice, for the Respondent