HCIA 7/2004

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF APPEAL

INLAND REVENUE APPEAL NO. 7 OF 2004

BETWEEN

KIM ENG SECURITIES (HONG KONG) LIMITED Appellant

and

COMMISSIONER OF INLAND REVENUE Respondent

Before: Hon Rogers VP, Le Pichon and Cheung JJA in Court
Date of Hearing: 28 February 2006
Date of Handing Down Judgment: 29 March 2006

J U D G M E N T

Hon Rogers VP:

1. This was an appeal by way of case stated under the provisions of section 69 of the Inland Revenue Ordinance Cap. 112 ("the Ordinance"). The decision of the Board, dated 28 October 2003, was in respect of the appellant's appeal from the determination of the Acting

Commissioner relating to additional profits tax assessment in respect of 4 types of income. An order was made by one of the members of this court on 22 February 2005 that the Board should set out fully the facts of the case. At the conclusion of the hearing of this appeal judgment was reserved which we now give.

2. The appellant is incorporated in Hong Kong and a member of the Hong Kong Stock Exchange. It would appear that it has at all times been a wholly owned subsidiary of one or other Singapore company and is now owned by Kim Eng Holdings Ltd which is listed in Singapore. There are a number of other companies around the world, including Kim Eng Securities (Private) Ltd ("KES") in Singapore, which are also owned by Kim Eng Holdings Ltd. They will be referred to collectively as the Group.

3. The managing director of KES, at least at the relevant time, was Mr Ooi Thean Yat Ronald Anthony. He is resident and works in Singapore. He was also the managing director of Kim Eng Holdings Ltd. He was responsible for the strategy and direction of the Group and oversees the conduct of the Group's business as well as the daily operations of KES. Another important person in the Group's affairs is Ms Gee Gek Leng, who was at all material times a director of both Kim Eng Holdings Ltd and KES. She oversaw the finance, operations, compliance, internal audit, administration and other matters of the Group.

4. The matters in issue in this case relate to dealings in respect of stocks traded on stock exchanges in overseas countries including Singapore, Malaysia, the Philippines, Shanghai and Indonesia. As set out in the case stated, in about 1990, the Kim Eng Group adopted a system to circumvent the minimum commission rules prescribed by the Singapore Stock Exchange. Stockbrokers in Singapore were permitted to rebate one half of the commission to foreign brokers. As will be explained below, I consider that much of the difficulty in this case stems from the use of the word "rebate". Unless the facts set out in the case stated have been misunderstood, it would be more accurate to say that KES charged foreign brokers 50% of the minimum commission. A foreign broker was one who was not a member of the Singapore Stock Exchange but one who held a dealer's licence from another exchange. The appellant fell into that category. In consequence it was realised that the Group as a whole could provide a cheaper, and thus more competitive, service to their clients if the appellant were to place orders for trades on the Singapore Stock Exchange on behalf of clients.

5. The operation of the system was that overseas clients would open accounts with the appellant. Many of those overseas clients were originally clients of KES, but other members of the Group were also what has been termed "source" brokers. Indeed, there were source brokers who were overseas and not members of the Group. There were thus account executives in Singapore and other places. They were employed by companies within the Group, or by the outside brokers. They would arrange for customers to sign account opening forms of the appellant. Blank forms were kept at various Group offices. The completed forms would be sent to the appellant in Hong Kong which would open an account in respect of the customer keeping account information on

their computers in Hong Kong. It would seem that sometimes the account opening was fairly informal: at paragraph 40Z of the case stated it was said that where the account opening forms were incomplete, or not returned, the appellant would input account information into its computers based on information it obtained from other sources.

6. The account executive who sourced the customer would service the customer by updating the customer with information and research materials produced by various Group companies. He would make recommendations, take orders and relay those orders to the appropriate stock exchange by liaising with the customer, the appellant and the executing broker. The account executive did so on behalf of his own employer who was acting also on its own behalf to earn income in the event that the customer placed an order for a trade on a stock exchange outside Hong Kong.

7. After execution of an order, where the account executive was not employed by KES, the appellant would send a trade confirmation to the customer. Where the account executive was a KES account executive, KES would send a trade confirmation to the customer in the name of the appellant and copy the appellant. The account executive, or the dealer in cases where the account executive was a KES account executive, would fax a booking sheet/trade confirmation summarising details of the executed order to the appellant's settlement department. The appellant would then generate bought/sold notes and send them to the customer directly by post and would also generate an "unsettlement" report of all the outstanding transactions of the day to be settled and fax that to the executing broker to handle settlement. The generation of the bought/sold notes would appear to be a particularly significant fact because it meant that the client was billed by the appellant.

8. The net effect of the transactions was that KES would obtain one half of the minimum commission and leave the other half, termed the rebate, to be shared between the appellant and the customer. In some instances, the customer apparently had a significant bargaining power. Specifically, fund managers were entitled to a 25% rebate of commission if they dealt directly with a Singapore stockbroker, such as KES. Thus the amount that the appellant could charge a fund manager was limited by the fact that unless the fund manager received at least a 25% discount or more on the commission, the Group would be giving him no advantage.

9. The way that settlement was made was set out at paragraph 40AH of the case stated. Sometimes the customer would pay KES. In those cases KES would pay the clearing house the amount due, keep what the appellant had to pay KES and pay the balance into the appellant's bank account in Singapore. In the cases where the customer paid the appellant by cheque, KES would pay the cheque into the appellant's bank account in Singapore and withdraw the purchase price and what the appellant had to pay KES. Where there was settlement of sale by a "delivery against payment customer" KES would pay the appellant's share into the appellant's bank account in Singapore after it had received payment from the buyer through the clearing house. There was a running account kept between KES and the appellant and payments were made on an end of day

basis rather than on a transaction by transaction basis. It would appear from paragraph 40AI of the case stated that the custodian customers would be paid from the appellant's bank accounts in Singapore.

10. Whilst the Singapore Stock Exchange permitted some securities to be dealt with on margin, stockbrokers in Singapore were not permitted to provide margin facilities in respect of the remaining securities quoted on the stock exchange. Part of the reason for routing trades through the appellant was so that the appellant could provide margin facilities in respect of "non-marginable" securities. It would seem that Mr Ooi and Ms Gee made the decisions as to whether to provide margin facilities. The funds to provide those facilities came from outside Hong Kong specifically either from Kim Eng Holdings Ltd, the Malaysian company in the Group or the appellant's own bank accounts in Singapore or Malaysia. Nevertheless, it was the appellant who would bill the clients.

11. As set out in paragraph 8 of the case stated, it was the appellant that would charge "contango commission" which was charged if a customer did not settle the balance due on the purchase of shares within 90 days of the date of purchase. It did so under the terms of the agreement it had with the clients.

12. The remaining category of charges related to those where the appellant was engaged so that it could charge the same rate of commission for each account when a customer was dealing on behalf of several accounts which would otherwise have to be charged at separate rates depending on the volume for each account. Charging at separate rates presented a problem with regard to the United Kingdom compliance rules. Routing the deal through the appellant enabled the same rate of commission to be charged in respect of each account. There was thus no difficulty with the United Kingdom rules and no difficulty with regard to the rules of the stock exchange on which the trade was done.

13. The crucial part of the reasoning of the Board was set out in paragraph 51 of the case stated:

> "In the Board's Decision, the appellant was not brought into the picture, did not earn its share of the minimum commission and was not paid for "effecting and executing the trades outside Hong Kong". Of course, the appellant would not have earned its share of the minimum commission if the overseas brokers had not executed the relevant transactions, and these took place abroad, but this does not tell us why the appellant came into the picture at all. What the appellant was doing to earn its share of the commission was bringing together the complementary needs of the customer (to pay less than the minimum commission) and the overseas broker (to earn a portion of the minimum commission from customers who were not prepared to pay the minimum commission), and that bringing together the appellant did in Hong Kong by:-

(a) opening a trading account for a customer upon notification by an overseas account executive, or in the case of a customer solicited by its own account executive;

(b) taking note of settlement procedure/instructions;

(c) booking trades as confirmed by the overseas account executive and executing broker;

(d) matching confirmations;

(e) generating contract notes and related settlement and accounting documents for trade;

(f) following up on settlement of trades with the account executive and the executing broker (if necessary) and updating records accordingly;

(g) making book entries of the transactions and reconciling statements; and

(h) preparing/generating reports on commission."

14. The question of law was framed as:

"Whether, having regard to all the facts as found by the Board of Review, and on the true construction of section 14 of the Inland Revenue Ordinance (Cap. 112), the Board of Review was correct in holding that the relevant profits of Kim Eng Securities (Hong Kong) Ltd. for the years of assessment 1995/96 and 1996/97 arose in or were derived from Hong Kong."

15. There was a second question as to whether the Board should have considered the question of apportionment.

16. The starting point of the consideration of the first question must be section 14 of the Ordinance which provides:

"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."

17. In my view, the question involved in this case is answered simply by the fact that the appellant made a profit because it charged its customers, more than it was charged by KES or the other overseas brokers. It was able to do so because it had contracts with the customers. As was explained by the Privy Council in the case of *Commissioner of Inland Revenue v Hang Seng Bank Ltd* [1991] 1 AC 306 at 322H – 323C:

> "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 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. There may, of course, be cases where the gross profits deriving from an individual transaction will have arisen in or derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case the absence of a specific provision for apportionment in the Ordinance would not obviate the necessity to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong."

18. In explaining the approach to construction of the section the Board referred to Atkin LJ's judgment in *F. L. Smidth and Company v F. Greenwood (Surveyor Of Taxes)* [1921] 3 KB 583 at 593. In that case the Court was not dealing with the question of where profits arose or were derived from but was dealing with the question:

> "…..whether the profits brought into charge are "profits arising or accruing" to the respondents "from any trade ... exercised within the United Kingdom" within the meaning of Sch. D of the Income Tax Act, 1853. The question is not whether the respondents carry on business in this country. It is whether they exercise a trade in this country so that profits accrue to them from the trade so exercised."

19. Lord Atkin had used the expression "I think that the question is, where do the operations take place from which the profits in substance arise?" This was taken up by the Board in *Commissioner of Inland Revenue v HK-TVB International Ltd.* [1992] 2 AC 397

> "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." "

20. Recognising that it is the provisions of section 14 which are all important and that the guidance offered in the cases are useful tools but not the provisions of the statute, in my view in this case the question of where the profits arose can only be answered one way. The profits arose because of the contractual arrangements between the appellant and the customers. These were contracts of the appellant in Hong Kong. The profit arose or were derived from the various charges raised in the bought/sold notes. These documents were created in and sent deliberately from Hong Kong.

21. The argument on behalf of the appellant that the profits arose in Singapore or the other countries where the securities were purchased or sold because it was those trades which generated the profits is attractive but misses the point. It misses the point because the bill presented to the customer came from the appellant in Hong Kong. As mentioned above, the use of the word rebate has perhaps added to confusion in the case. If it had been the Singapore or other executing brokerage that had billed the client and then deposited some money into the appellant's bank account overseas there might be some validity in the argument that the profit arose overseas by reason of a transaction which was entirely an overseas transaction or a transaction carried out entirely overseas by an agent of the appellant. But that is not the case here. In this case the profit arose because it was the appellant that charged the customer and, in effect, had to pay less to the overseas broker than it charged the customer.

22. In these circumstances, it appears to me that it matters not that the appellant's bank accounts were maintained abroad, nor that the important controlling minds of the appellant namely Mr Ooi and Ms Gee were overseas. Nor from the other perspective do I consider it determinative that the appellant's records and other back-office operations were in Hong Kong. Some of the matters referred to in paragraph 51 of the case stated could be classified as back office operations. What matters is that the appellant was deriving its profits from its Hong Kong business namely its Hong Kong contractual arrangements with the customers.

23. There remains only the second question, namely as to whether the Board should have considered the question of apportionment. The Board refused to do so because the issue as to whether there should be apportionment was raised very late during the hearing before the Board. Moreover, the Board had little or no material on which to assess the matter. In my view, the Board's approach was correct. I would add, however, that it would appear that the overseas elements in the transactions had already been catered for by reason of the commission that would be received by KES and the other brokers engaged by the appellant to perform the various trades on the stock exchanges in Singapore and elsewhere and by the share of commission that any source brokers would be entitled to.

24. I would therefore answer the questions accordingly, dismiss this appeal and make an order *nisi* in favour of the Commissioner.

Hon Le Pichon JA:

25. I agree that the appeal be dismissed for the reasons given by Hon Rogers VP.

Hon Cheung JA:

26. I agree with Rogers VP that this appeal should be dismissed.

Profits arising in or derived from Hong Kong

27. This appeal raises once again the familiar but often difficult question of the location of the source of income for the purpose of taxation.

28. Section 14(1) of the *Inland Revenue Ordinance* ('IRO') levies profits tax on a person who carries on a trade, profession, or business in Hong Kong in respect of his assessable profits 'arising in or derived from Hong Kong' from such activities.

The principles

29. In order to determine whether the assessable profits are 'arising in or derived from' Hong Kong or elsewhere it is worth repeating the following guidelines.

(1) The starting point is that three conditions must be satisfied:

1) the taxpayer must carry on a trade, profession or business in Hong Kong

2) the profits to be charged must be 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

(*Commissioner of Inland Revenue v. Hang Seng Bank Limited* [1991] 1 AC 306)

(2) In order to determine whether gross profits resulting from a particular transaction arose in or derived from a particular locality, one looks to see what the taxpayer has done to earn the profits in question and where he has done it.

(*Hang Seng Bank Limited* and *Commissioner of Inland Revenue v. HKTVB International Limited* [1992] 2 AC 397)

(3) The ascertaining of the actual source of income is a 'practical hard matter of fact' (*Liquidator, Rhodesia Metals Ltd v. Commissioner of Taxes* [1940] AC 774). This effectively means that while one must not disregard the accurate legal analysis of transactions, one must grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters (*Kwong Mile Services Ltd v. Commissioner of Inland Revenue* (2004) 7 HKCFAR 275)

30. It is also important to bear in mind the strictures that are imposed on appeals from the Board of Review which are confined by statute to points of law only.

(1) The constant theme from *Edwards (Inspector of Taxes) v. Bairstow* [1956] AC 14 to *Begum v. Tower Hamlets London Borough Council* [2003] 2 AC 430 has always been:

> "A decision may be quashed if it is based on a finding of fact or inference from the facts which is perverse or irrational; or there was no evidence to support it; or it was made by reference to irrelevant factors or without regard to relevant factors. It is not necessary to identify a specific error of law; if the decision cannot be supported the court will infer that the decision-making authority misunderstood or overlooked relevant evidence or misdirected itself in law."

per Lord Millett in *Begum*.

(2) As Bokhary PJ in *Kwong Mile Services Ltd* observed the three relevant propositions in this exercise are:

> "(1) In an appeal on law only the appellate court must bear in mind what scope the circumstances provide for reasonable minds to differ as to the conclusion to be drawn from the primary facts found.
>
> (2) If the fact-finding tribunal's conclusion is a reasonable one, the appellate court cannot disturb that conclusion even if its own preference is for a contrary conclusion.
>
> (3) But if the appellate court regards the contrary conclusion as the true and only reasonable one, the appellate court is duty-bound to substitute the contrary conclusion for the one reached by the fact-finding tribunal."

Commissions

31. The taxpayer challenged the contention that its share of commissions which was derived from security transactions in overseas countries is subject to Hong Kong tax. Although such transactions included transactions in Singapore, Malaysia, Shanghai and the Philippines, Mr Stewart Wong, counsel for the taxpayer, focused his challenge entirely on transactions in Singapore. As I understand it, the effect of this approach is that this appeal will be determined by reference to the Singapore transactions.

The taxpayer's case

32. The crux of the case of the taxpayer, which has been thoroughly put forward by Mr Wong, is that the operative or effective cause which enabled taxpayer to earn its share of the commission was the execution of the orders for the purchase/sale of securities in Singapore. The execution was done by the taxpayer, through its Singapore counterpart (as its agent) in Singapore. On that basis the profit, namely the taxpayer's share of the commission which is the subject matter of the assessment, arose in and derived from Singapore and not in Hong Kong. The other acts done by the taxpayer were antecedent or incidental matters.

Basis of the taxpayer's involvement

33. This is an attractive argument and at first brush tallies with the approach in *Hang Seng Bank Limited*. However, it is important to bear in mind that it was the taxpayer's own case that it was involved in these security transactions for two reasons:

1) It will enable the client to pay less commission than otherwise it would be required to do so if it directly instructed the taxpayer's Singapore counterpart. At the same time the Singapore counterpart will still be able to comply with the Singapore statutory requirement of charging the 'minimum' or standard commissions. This 'win-win' situation is achieved because the Singapore counterpart is entitled under Singapore law to pay from its 'minimum commission' rebates to the taxpayer as an overseas stock broker. This rebate in turn is shared between the taxpayer and the customer. The effect is that the client will in substance pay less than the 'minimum commission' to the Singapore counterpart. This system was described as the 'circumvention scheme' and according to the finding of the Board of Review it began in 1990 by the Kim Eng Group of Companies of which the taxpayer is a member.

2) It will also enable the client to receive margin facilities which otherwise it would not be able to do if it instructed the Singapore counterpart directly because Singapore Stock Exchange restricted the provision of margin facilities to securities on its prescribed list. But if the client is a customer of the taxpayer then

the taxpayer is able to extend margin facilities to enable it to trade in Singapore securities.

34. The second reason is, of course, related to the appeal on the interest received by the taxpayer on the margin accounts.

The crucial connection

35. On the basis of the first reason, in my view the Board of Review was entitled to find that it was crucial that the account through which the client traded was with the appellant in order to achieve the circumvention scheme. And on this basis, in my view it is extremely artificial to say that the contract between the taxpayer and the client merely provides an 'opportunity' but not the 'effective cause' for the taxpayer to earn its share of the commission, or that the acts done by the taxpayer were merely antecedent or incidental matters. To do so would lead one to ignore the reality of the situation and ignore some very important evidence when one 'looks to see what the taxpayer has done to earn the profits in question and where he has done it'. This will be contrary to the 'practical hard matter of fact' inquiry approach.

36. In my view the Board was correct when it decided that,

> "What the appellant was doing to earn its share of the minimum commission was bringing together the complementary needs of the customer (to pay less than the minimum commission) and the overseas broker (to earn a portion of the minimum commission from customers who were not prepared to pay the minimum commission), and that bringing together the appellant did in Hong Kong by:-
>
> (a) opening a trading account for a customer upon notification by an overseas account executive, or in the case of a customer solicited by its own account executive;
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> (b) taking note of settlement procedure/instructions;
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> (c) booking trades as confirmed by the overseas account executive and executing broker;
>
> (d) matching confirmations;
>
> (e) generating contract notes and related settlement and accounting documents for trade;
>
> (f) following up on settlement of trades with the account executive and the executing broker (if necessary) and updating records accordingly;

(g) making book entries of the transactions and reconciling statements; and

(h) preparing/generating reports on commission."

37. At the very least, this was clearly a reasonable decision which was opened to the Board to find based on the facts of this case. I am not persuaded that the finding that in relation to the taxpayer's share of the commission it arose in or derived from Hong Kong was an error at all.

Interest on margin accounts

38. By parity of reasons, the Board's finding that,

> "what the appellant was doing to earn its income from margin accounts and commission from trades of the margin account customers was bringing together the complementary needs of the customer (to obtain margin trading facilities with "non-marginable" securities as securities) and the overseas broker (to earn commission from transactions on the overseas stock exchange), and that bringing together the appellant did in Hong Kong."

was a correct one and was also a reasonable decision that it was entitled to make on the facts of this case.

Source of funding

39. The fact that the funds of the facilities were sourced in Singapore and used in Singapore could not be determinative of the issue whether the interest from the facilities was of a foreign source. To do so would turn the example given by Lord Bridge in *Hang Seng Bank Limited* that ' if the profit was earned by.... lending $..... the profit will have arisen in or derived from the place where... the money was lent,' into a principle of law when the inquiry on the location of the source is fact sensitive in nature.

Commissioner of Inland Revenue v. Wardley Investment Services (Hong Kong) Ltd

40. Mr Wong had submitted that the decision of this Court (Cons VP, Fuad VP and Penlington VP) in *Commissioner of Inland Revenue v. Wardley Investment Services (Hong Kong) Ltd* (1992) 3 HKTC 703 was wrong. It was held by a majority that the rebate commission given by an overseas broker to the taxpayer was subject to tax. The taxpayer was an investment adviser for clients and gave instruction to the overseas broker to execute security transactions on behalf of clients. Fuad VP for the majority held that:

> "... the Taxpayer did nothing abroad to earn the profit sought to be taxed. The Taxpayer would be acting in precisely the same manner, and in the same place, to earn its profit, whether it was giving instructions, in pursuance of a management contract, to a broker in Hong Kong or to one overseas. The profit to the Taxpayer was generated in Hong Kong from that contract although it could be traced back to the transactions which earned the broker a commission."

41. It is important to bear in mind that the question whether an income is from an overseas source or not will depend on the individual facts of the case. The present appeal also turns on its unique facts. This being the case, the correctness or otherwise of *Wardley Investment Services (Hong Kong) Ltd* is not something this Court needs to deal with in this appeal.

Apportion

42. I agree with the views of Rogers VP on the question of apportionment.

Hon Rogers VP:

43. There will therefore be an order in turns of paragraph 24 above.

(Anthony Rogers)	(Doreen Le Pichon)	(Peter Cheung)
Vice-President	Justice of Appeal	Justice of Appeal

Mr Steward K M Wong, instructed by Messrs Lee & Li, for the Appellant

Mr John Bleach SC & Mr Jin Pao, instructed by Department of Justice, for the Respondent