



**Mr Justice Bokhary PJ:**

1. Whether profits are of Hong Kong source and therefore taxable or of foreign source and therefore not taxable is a practical, hard matter of fact. And it is a matter on which there is room for reasonable minds to differ. So there can be circumstances in which the matter can reasonably be decided either way. In the present case, the Board of Review did not actually decide the issue of source one way or the other. Instead the Board simply held that the taxpayer had not discharged its onus under s.68(4) of the Inland Revenue Ordinance, Cap.112, of proving that the determination appealed against is excessive or incorrect.

2. Barma J's decision in favour of the taxpayer on the issue of source was reversed by the Court of Appeal on the basis of their view to the effect that he had strayed beyond what it was open to him to do in an appeal on law only. I can understand the Court of Appeal's point of view, but am ultimately of the view that Barma J did not so stray. If he appears to have done more than what judges are normally called upon to do in appeals from the Board of Review, that is due, I think, to the natural and proper inclination of civil courts to decide cases, if at all possible, on the basis of something more satisfying than the onus of proof.

3. I would allow the appeal to order that the assessments for each of the relevant years be reduced by excluding the disputed profits. And I would direct that costs be dealt with on written submissions as to which the parties should seek procedural directions from the Registrar.

4. Before parting with this case, I would observe that it is but one illustration of the extent to which the work to be performed by the Board of Review has, over the years, grown more complex and time-consuming. So much so that there appears much to be said for urgent consideration being given, in the appropriate quarters, to the question of whether the public interest in present-day Hong Kong calls for, if not a new body composed of full-time personnel to take over some or all of the Board's work, then at least an overhaul of the way in which the Board is constituted and resourced. This involves no criticism of those willing to take time out of their busy schedules to serve on the Board. What it does perhaps involve is whether it is fair to expect them to do so under present conditions.

**Mr Justice Chan PJ:**

5. I agree that the Taxpayer's appeal should be allowed. I reach this conclusion not without much difficulty, particularly over the placement income and marketing income. Such difficulty had arisen largely as a result of the great discrepancies between the figures originally returned and the revised figures submitted to the Commissioner; the different format adopted in some of the accounting records presented to the Commissioner; the different terms used for the

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different types of commission received; and the different ways in which the Taxpayer chose to present its case to the Commissioner and the Board of Review (“the Board”) and, in relation to some of the issues, also before the lower courts and this Court. This was aggravated by the huge volume of documents produced before the Board; only some but not all of the documents were placed before this Court. This difficulty could be illustrated by the many instances when leading counsel for the Taxpayer had to seek instructions from those instructing him in an attempt to clarify some of the doubts this Court had entertained. This is highly unsatisfactory, to say the least.

6. It is not disputed that the broad guiding principle in determining the source of income for profit tax purposes under s.14 (1) of the Inland Revenue Ordinance, Cap 112 is to examine what the taxpayer has done to earn the profit in question and where he has done it (see Lord Bridge of Harwich in *C.I.R. v Hang Seng Bank Ltd* [1991] 1 AC 306, 323 and Lord Jauncey of Tullichettle in *C.I.R. v HK-TVB International Ltd* [1992] 3 WLR 439, 444). In performing this task, it is necessary to consider “the nature of the different transactions by which the profits are generated” (Lord Bridge of Harwich at 319B). See also Sir George Rankin in *Commissioner of Income Tax, Bombay Presidency and Aden v Chunulal B. Mehta of Bombay* (1938) LR 65 Indian Appeals 332, 345.

7. In my view, the Board, having discussed the relevant authorities, failed to apply the guiding principle to this case. Instead of examining the nature of the transactions by which the Taxpayer earned its incomes (in the form of commissions and charges) and the role it had played to earn them, the Board looked in vain for evidence which, if the correct principle were applied, would be largely irrelevant. (See the comments made by Mr Justice Ribeiro PJ in his judgment.) Having made only some findings of fact and raised a large number of queries, the Board came to the conclusion that the Taxpayer had failed to discharge the burden of showing that the assessments by the Commissioner were erroneous. The principal difficulty facing the courts is whether, in the absence of specific findings of the relevant facts, there was sufficient evidence to conclude that the incomes in dispute were earned offshore and thus not taxable under s.14 (1) of the Ordinance. The judge held that there was but the Court of Appeal disagreed holding that the judge should not have embarked on a fact-finding exercise. This again highlighted the difficulty which this case had created.

8. If there was sufficient evidence to draw the conclusion that the assessments were incorrect, then the appeal must be allowed. On the other hand, if there was not sufficient evidence to do so, the Taxpayer failed to discharge the statutory burden and this appeal must be dismissed. In my view, there was just sufficient evidence to draw the conclusion that the disputed incomes were derived outside Hong Kong.

9. The Taxpayer’s business was that of undertaking, on behalf of its own clients and those of its group companies, the “trading of securities listed in global stock markets”. This involved the buying and selling of securities in various stock exchanges, both in and outside Hong Kong. It was through these transactions that the Taxpayer earned its commissions and charges which were

payable only after the completion of the transactions. These transactions were not completed until after they had been executed; and execution took place at the stock exchange where the securities were traded. Thus, while other steps taken in relation to the trading are relevant, the crucial step is usually the execution of the transaction for sale and purchase. In the present case, we are not concerned with the Taxpayer's incomes arising from the trading of securities in Hong Kong but in stock exchanges outside Hong Kong.

10. With regard to the trading of securities and similar commodities, the authorities support the view that where the activities resulting in the earning of profits happened overseas, the incomes derived from these activities would normally be regarded as offshore incomes. In *Hang Seng Bank*, the bank was engaged in the purchase and resale of certificates of deposits outside Hong Kong. The profits earned from such trading were held to be offshore since the activities which resulted in such profits were conducted overseas. Similarly, in *Mehta*, the taxpayer, a resident in British India, entered into contracts for the sale and purchase of commodities outside British India. The profits earned from these transactions were held by the Privy Council to have been earned overseas.

11. A different conclusion was, however, reached in *C.I.R. v Wardley Investment Services (HK) Ltd* (1992) 3 HKTC 703 but this was based on the special terms of the management agreements in that case. There the taxpayer, an investment adviser, was engaged in managing customers' investment portfolios, including the sale and purchase of securities on their behalf through brokers, at agreed management fees calculated as a percentage of the funds managed by it. Under their management agreements, the taxpayer was entitled to receive rebates from brokers instructed to perform the transactions. The majority of the Court of Appeal held that while the transactions from which the commission rebates were derived were carried out overseas, these rebates in fact formed part of the remunerations provided for under the management agreements and were thus incomes earned in Hong Kong. In *Kim Eng Securities (Hong Kong) Ltd v C.I.R.* [2007] 2 HKLRD 117, there was a good reason for coming to a different conclusion as that in *Hang Seng Bank* and *Mehta*. There, customers of a Singaporean group of companies of which the taxpayer was a member were referred to the taxpayer only after the trading of securities in Singapore and other places outside Hong Kong had been completed by other entities. This was done for the purpose of circumventing certain restrictions prescribed by the Singapore Stock Exchange regarding rebates and marginal facilities. This Court held that in playing such a role, what the taxpayer did to earn its net commission was done in Hong Kong. Although a different conclusion was drawn in *Wardley* and *Kim Eng*, neither of them doubted the correctness of the decisions in *Hang Seng Bank* and *Mehta*.

12. Three types of income are in dispute in this case: commission income; placement income and marketing income. The question is: what had the Taxpayer done in earning these incomes? It is necessary to examine its role in the relevant transactions. In this connection, I would gratefully adopt the detailed description of the facts given by Mr Justice Ribeiro PJ and Lord Millett

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NPJ in their judgments. Leaving out the details, the broad position regarding each of these three types of income can be summarized below.

13. In respect of commission income, the available evidence (which was accepted by the Board) showed that the position was as follows. If a client in Hong Kong gave instructions to the Taxpayer to trade in securities in an overseas stock exchange, the Taxpayer, acting as the counter-party, passed on this order to a group company (described as the executing entity) at the place where the stock exchange was located. If that group company had the requisite trading licence, it would execute the order, and if it did not have such a licence, it would ask a third party which had to do so. Where a client outside Hong Kong gave instructions to a group company (in the same location as the client) to trade in securities in an overseas stock exchange, such order would either be communicated to the Taxpayer which (again acting as the counter-party) would pass it on to another group company in the place where the stock exchange was for execution or be communicated directly and almost contemporaneously to that group company for execution. In both situations, the transaction (i.e. sale and purchase of the securities) was carried out in the overseas stock exchange with the Taxpayer as the counter-party. Commission income was payable upon completion of the transaction. Such income was clearly earned offshore, since the activities which resulted in the payment of the commission were carried out outside Hong Kong. The fact that it was allocated to the Taxpayer and other group companies according to the policy of the Group does not affect the conclusion that such income was as a matter of fact earned offshore.

14. Placement income was derived from commissions received upon successful allotment of new shares issued or listed outside Hong Kong. When new shares were issued or listed in a foreign stock exchange, usually an Asian stock exchange, clients of the Taxpayer and those of the Group who were interested would apply for allotment through the Taxpayer and other group companies. Such applications were passed on to the Taxpayer which would consolidate all the orders and transmit them to the group company where the new issue or listing was located. Not all the applications would necessarily be successful and only a portion of the shares applied for might be allocated. The Taxpayer then informed the group companies of the result of the applications, the number of shares allocated and the amounts of money involved. Since the allotment of these newly issued or listed shares was made in a foreign stock exchange and commission was only payable upon a successful allotment, the commission which was the result of activities conducted overseas must be regarded as having been earned offshore. The steps taken by the Taxpayer in consolidating all the orders, transmitting them to the relevant foreign stock exchange and its co-ordination after the allotment were merely incidental and ancillary to the earning of such commission. So while the steps which the Taxpayer had to take to earn placement income were not the same as those for earning commission income, the activities which resulted in the earning of income were conducted in both cases in a foreign stock exchange. They should both be regarded as offshore incomes. There is, in my view, nothing to differentiate between commission income and placement income as far as the sources of these incomes are concerned. Again, the allocation of commission according to fixed company policy is not relevant to the question of the source for the purpose of profits tax.

15. The last item in dispute was marketing income. This type of income was governed by intra-group commission agreements which contained similar terms. A total of six such agreements had been produced. It is not necessary to go into the details of these agreements. What was in common in these agreements was that for the introduction of clients by the Taxpayer to other group companies for equities trading in Asian markets, such as Japan, Korea, and Singapore, the Taxpayer would be entitled to an introduction commission which was in fact a portion (up to 50%) of the net commission received by the group company involved in the equities trading (acting either as the booking party or the executing entity). There was some uncertainty as to whether it was the booking party or the executing entity which received the commission in the first place and whether payment of such commission was the result of the Group's internal arrangements. But whatever the arrangements were, what was done by the Taxpayer was introducing clients to the relevant group companies but this introduction did not in itself result in the payment of commission to the Taxpayer. It was payable only upon completion of trading in securities which took place in foreign stock exchanges. The activities which resulted in the earning of marketing income by the Taxpayer (albeit in accordance with the intra-group commission agreements) were conducted overseas.

16. At the end of the day, having considered the role of the Taxpayer in these transactions in the light of the nature of the transactions from which incomes were earned, I am satisfied that there was sufficient evidence upon which the Court can draw the conclusion that the disputed incomes were derived outside Hong Kong and are thus not liable to profits tax under s.14. The Commissioner's assessments were incorrect and this appeal must be allowed. In view of the peculiar circumstances of this case, I would agree with Mr Justice Bokhary PJ that the question of costs should be left to be dealt with by written submissions.

17. Finally, I would respectfully agree with the remarks and suggestions made by Mr Justice Bokhary PJ regarding the structure and operation of the Board of Review. In this modern commercial and financial age, while some appeals to the Board may be straightforward, there are others which require a tremendous amount of expertise and they are unlikely to be adequately and efficiently dealt with by members working on a part time basis.

**Mr Justice Ribeiro PJ:**

18. I have had the advantage of reading in draft the judgment of Lord Millett NPJ. I respectfully agree with its reasoning and conclusion. In this judgment I set out why, in my view, it would be wrong to conclude, as did the Board of Review and the Court of Appeal,<sup>1</sup> that the Appellant Taxpayer has failed to discharge the onus of proving that the assessment appealed against was incorrect or excessive.<sup>2</sup>

19. In my judgment, many of the Board's complaints about perceived deficiencies in the evidence were based on a misapprehension of the governing legal principles in their application to

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<sup>1</sup> [2006] 3 HKLRD 315.

<sup>2</sup> Imposed by section 68(4) of the Inland Revenue Ordinance, Cap 112.

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the present facts. This led to repeated complaints as to the insufficiency of evidence regarding matters having no relevance to the issues in the case. Other complaints were inconsequential or speculative or made having lost sight of facts agreed between the parties. In my view, the evidence and findings of the Board provide an ample basis for holding that, on the law properly applied, the disputed profits did not arise in and were not derived from Hong Kong.

**A. The issue**

20. As the Board acknowledged, “[the] business of the Taxpayer (and the international group of compan[ies] to which it belongs) is to undertake on behalf of clients of the Taxpayer (and its group of companies) trading of securities listed in global stock markets.”<sup>3</sup>

21. The dispute concerned the Taxpayer’s liability for profits tax for the five consecutive years of assessment<sup>4</sup> beginning with the year 1990/1991. In its initial returns, the relevant profits were stated as follows:

	<u>1990/91</u>	<u>1991/92</u>	<u>1992/93</u>	<u>1993/94</u>	<u>1994/95</u>
Profits returned for assessment	32,957,451	13,839,658	75,305,049	127,438,074	27,678,658
Offshore incomes	26,086,970	40,966,000	33,480,000	40,351,435	25,255,605
Offshore sub-underwriting Commission	156,379	2,539,423	8,994,129	---	---
Other offshore incomes	---	---	6,841,946	---	---

22. The Taxpayer subsequently submitted a revised return for the first three years in question, stating its profits as follows:

	90/91 \$	91/92\$	92/93 \$
Revised profits offered for assessment	4,259,368	22,317,988	74,775,178
Revised offshore incomes	70,985,000	60,465,000	68,054,000
Offshore sub-underwriting Commission	156,379	---	---
Other offshore incomes	---	---	6,841,946

As is apparent, the figures in each of these years, both for total profits and for profits said to derive from offshore incomes, were significantly increased. The taxpayer offered up for assessment

<sup>3</sup> Case Stated §2.

<sup>4</sup> The figures for 1992/1993 referred to the period ending 31 December 1993 since that was when the Taxpayer changed its financial year end from 30 September to 31 December.

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profits deriving from securities transactions executed on the Hong Kong Stock Exchange while claiming that profits from transactions on foreign markets fell outside the charge to profits tax. The latter category of income is the subject of the dispute.

23. The Taxpayer divided the disputed profits into three categories which it described as placements income, commission income and marketing income, as set out in the following table:

	1990/91	1991/92	1992/93	1993/94	1994/95
	<u>\$000s</u>	<u>\$000s</u>	<u>\$000s</u>	<u>\$000s</u>	<u>\$000s</u>
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)	---
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
	130,623	96,271	110,597	156,345	209,650
Expenses	(59,638)	(35,806)	(42,543)	(114,850)	(184,678)
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	70,985	60,465	68,054	41,495	24,972
Adjustments for expenses, deprn and rebuilding allowances	---	---	---	(1,143)	284
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Offshore incomes	<u>70,985</u>	<u>60,465</u>	<u>68,054</u>	<u>40,351</u>	<u>25,256</u>

24. The abovementioned figures were formally agreed and included in a Statement of Agreed Facts.<sup>5</sup> Additionally, a breakdown of the disputed profits according to the country in which they were said to have arisen was provided in Appendices to that Statement.<sup>6</sup>

25. The issue between the parties was therefore one of principle relating to the geographical source of the profits, there being no dispute as to the quantum of the income earned by the Taxpayer. The Board recorded their submission to that effect:

23. We have been asked by both parties to decide whether the Placements Income, the Commission Income and the Marketing Income were profits of the Appellant which arose or derived from Hong Kong from the Appellant carrying on a trade, profession or business in Hong Kong.

24. Counsel for both parties submitted that the dispute related to whether the 3 categories of disputed incomes were taxable in Hong Kong as a matter of principle and that there was no dispute on the quantum of the income. We have thus not address the issue from the quantum point of view.<sup>7</sup>

<sup>5</sup> Statement of Agreed Facts §§3, 4 and 5.

<sup>6</sup> Statement of Agreed Facts Appendices B to B4.

<sup>7</sup> Decision §§23 and 24.



However, as indicated below, the Board did not always keep in mind the limited scope of the dispute and the area of agreement established by the parties.

**B. The evidence**

26. This is not a case involving sparse evidence. Voluminous documentary evidence was placed before the Board including correspondence between the Revenue on the one hand and the Taxpayer, its parent company (Baring Securities Limited) and one of its tax representatives (Coopers & Lybrand) on the other. Apart from the profits tax returns, the Taxpayer furnished samples of customer account agreements and documentation relating to the execution and settlement of client trades in respect of the seven countries in which the relevant securities were traded. It also provided copies of intra-Group Commission Agreements and related documents. Of such sample documentation, the Board remarked:

“The manner of segregation of the sample documentation by market was consistent with the criterion used by the Appellant to classify whether a certain income was onshore or offshore subject to the two peculiarities which we have noted. Much of the sample documentation related to the execution and settlement of the client trades. There was also written evidence of the allocation of commission income in the sample documentation.”<sup>8</sup>

27. At the hearing (which lasted four days), three witnesses for the Taxpayer gave evidence and were subjected to cross-examination, having first filed witness statements dealing with the matters in issue.

28. The first was Mr Ramsay Urquhart who had been financial controller in Hong Kong between January 1994 and March 1997 and who had signed the 93/94 and 94/95 Tax Returns. He gave evidence as to how commission income was allocated amongst various Group companies and presented what the Board described as “the numerous sample documents relating to the execution and settlement of client trades”.<sup>9</sup>

29. The second was Mr Patrick Lawlor who was head of information technology in Hong Kong from 1990 to 1996 and, after a stint as chief operating officer in Indonesia, returned to Hong Kong as business manager for Asian equities. He had helped set up automated client trade settlement systems and written a report on client order and execution flows in the Asian Group companies. He also “provided insight on the function of the research and sales”.<sup>10</sup>

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<sup>8</sup> Decision §39 c. The “peculiarities” mentioned appear to be those referred to in §22, which are discussed below in relation to criticisms considered inconsequential in Section E(1)(d) below.

<sup>9</sup> Decision §40a.

<sup>10</sup> Decision §40b.

30. Mr Paul Snead was the third witness. He had been head of operations in Indonesia and in Korea before becoming head of settlement in Hong Kong until 1996, when he took over as the London head of equities settlement. He gave evidence as to the nature of the Group's business and its the general operations "and shed further light on income allocation with the Group", corroborating Mr Urquhart's testimony on the sample documentation relating to client trades. He also gave evidence relating to placements income.<sup>11</sup>

**C. The legal principles**

31. It is only on the basis of a proper appreciation of the applicable legal principles that it is possible to determine what evidence is relevant and what findings the Board needed to make.

32. The charge to profits tax is contained in section 14(1) of the Inland Revenue Ordinance,<sup>12</sup> which materially states:

"... profits tax shall be charged 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 for that year from such trade, profession or business ..."

33. As pointed out in *Commissioner of Inland Revenue v Hang Seng Bank*,<sup>13</sup> it lays down three conditions for a charge to tax, namely:

"(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."<sup>14</sup>

34. In the present case, we are concerned with the third condition. It is common ground that the Taxpayer carries on a business in Hong Kong and that the profits referred to in its tax returns are the profits of that business. What follows from the third condition is that:

"...a distinction must fall to be made between profits arising in or derived from Hong Kong ('Hong Kong profits') and profits arising in or derived from a place outside Hong Kong ('offshore profits') according to the nature of the different transactions by which the profits are generated."<sup>15</sup>

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<sup>11</sup> Decision §40c.

<sup>12</sup> Cap 112.

<sup>13</sup> [1991] 1 AC 306.

<sup>14</sup> Per Lord Bridge, at 318E-F.

<sup>15</sup> *Ibid* at 319B.

35. Accordingly, to decide whether certain profits arose offshore one must focus on the nature of the taxpayer's transactions which gave rise to such profits. This is particularly apposite in a case like the present where the Taxpayer, carrying on business in Hong Kong, seeks to distinguish between profits deriving from its transactions within the jurisdiction and its transactions effected outside Hong Kong.

36. It is in that context that Lord Bridge's "broad guiding principle" is to be applied. One has to consider "what the taxpayer has done to earn the profit in question", looking at the nature of the transactions in question. As the Taxpayer provided agency brokerage services it is relevant to note that:

"If he has rendered a service ..., the profit will have arisen or derived from the place where the service was rendered ..."<sup>16</sup>

37. In *Commissioner of Inland Revenue v HKTVB International Ltd*,<sup>17</sup> Lord Jauncey added:

"... 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,'"<sup>18</sup>

38. In *Kwong Mile Services Ltd v Commissioner of Inland Revenue*, applying the abovementioned authorities, this Court noted the absence of a universal test but emphasised "the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters."<sup>19</sup> The focus is therefore on establishing the geographical location of the taxpayer's profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions. Such antecedent activities will often be commercially essential to the operations and profitability of the taxpayer's business, but they do not provide the legal test for ascertaining the geographical source of profits for the purposes of section 14.

39. In *Commissioner of Income-Tax v Chunilal Mehta*,<sup>20</sup> the Privy Council had to consider the operation of the Indian Income Tax Act 1922 which excluded from taxation profits which did not accrue or arise in British India. It was an Act which laid down a requirement, in all material respects indistinguishable from that in our Ordinance, that taxable profits be sourced within the jurisdiction. It concerned a broker whose profits consisted both of brokerage earned for executing contracts for clients and of profits arising from trading transactions executed for his own account in the purchase and sale of commodities outside India.<sup>21</sup> The broker's business was

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<sup>16</sup> *Ibid* at 323A.

<sup>17</sup> [1992] 2 AC 397.

<sup>18</sup> At 407C.

<sup>19</sup> (2004) 7 HKCFAR 275 at 283G, per Bokhary PJ.

<sup>20</sup> (1938) LR 65 Ind Appeals 332.

<sup>21</sup> *Ibid* at 341.

conducted entirely from Bombay where he kept track of prevailing prices and, using his knowledge, skill and judgment, decided what transactions to effect. He employed brokers abroad to execute the chosen trades.

40. In the Indian High Court, Beaumont CJ held that the profits were sourced abroad and fell outside the charge to tax.<sup>22</sup> In upholding that decision, the Privy Council adopted an approach very much in line with the principles established in the modern cases, focusing on the geographical location of the profit-producing transactions. Giving the judgment of the Board, Sir George Rankin stated:

“One must look at the transaction to see what happened in British India and what happened elsewhere. The intermediate links may be all-important. Here the profit is the difference between a sale and a purchase both effected in New York and then set off, and so far carried out in New York that a New York broker has money in his hands or under his control which as between himself and the assessee belongs to the assessee.

To determine the place at which such a profit arises not by reference to the transactions, or to any feature of the transactions, but by reference to a place in India at which the instructions therefor were determined on and cabled to New York is, in their Lordships’ view, to proceed in a manner which cannot be supported if the transactions are to be looked at separately and the profits of each transaction considered by themselves. ...’<sup>23</sup>

His Lordship concluded:

“... a person resident in British India, carrying on business there and controlling transactions abroad in the course of such business, is not by these mere facts liable to tax on the profits of such transactions. ... In the case before the Board the contracts were neither framed nor carried out in British India; the High Court’s conclusion that the profits accrued or arose outside British India is well founded.’<sup>24</sup>

41. The *Hang Seng Bank* case<sup>25</sup> was also concerned with profits deriving from offshore transactions. The bank, which carried on business in Hong Kong, invested its foreign currency surpluses in certificates of deposit on the Singapore and London markets and derived profits from re-selling them shortly before maturity, giving instructions for purchase and sale through correspondent banks.<sup>26</sup> Applying the “broad guiding principle” already referred to, the Privy Council held that the profits of those transactions arose or derived from sources outside Hong

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<sup>22</sup> AIR 1935 Bombay 423.

<sup>23</sup> (1938) LR 65 Ind Appeals 332 at 345.

<sup>24</sup> *Ibid* at 352.

<sup>25</sup> [1991] 1 AC 306.

<sup>26</sup> At 317.

Kong. In rejecting the argument that the profits were locally sourced “because it was in Hong Kong that the investment decisions were taken on a day to day basis in the exercise of the skill and judgment of officers in the bank's foreign exchange department”, the Privy Council applied the *Mehta* decision, describing it as authoritative and noting that there was no material difference to be ascribed to the wording of the respective Indian and Hong Kong statutory provisions.<sup>27</sup>

42. I will return later in this judgment to examine the evidence as to the nature of the transactions that gave rise to the disputed profits. But, I should say at once that in my view, the authorities discussed above clearly establish in principle that where a broker carrying on business in Hong Kong receives profits in the form of commission or analogous income earned only upon the successful execution of a securities transaction he has caused to be effected on his client's behalf in a securities market outside Hong Kong, it is that offshore trading transaction which ought to be regarded as the relevant profit-generating transaction on his part so that the resultant profits should not be regarded as arising in or derived from Hong Kong.

43. The Taxpayer's case is that it acted as such a broker. In so far as it earned profits by carrying out transactions for clients (who might be in Hong Kong or overseas) on the Hong Kong Stock Exchange, it has offered those profits up for assessment, accepting that commission and any other income so earned arose in Hong Kong. But in so far as its profits were earned by providing clients the service, through foreign brokers, of effecting securities transactions on foreign stock markets, it contends that the brokerage and other income so earned were sourced offshore. As noted in the Statement of Agreed Facts,<sup>28</sup> the Taxpayer's tax representative objected to the assessments:

“... on the grounds that certain incomes, including commission from placements of securities listed in overseas markets, commission from transactions in equities listed in overseas markets and marketing income from transactions in equities listed in overseas markets, were derived from places outside Hong Kong and were not chargeable to Hong Kong Profits Tax.”

44. The position, the Taxpayer submits, is in principle no different from that in the *Mehta* or *Hang Seng Bank* cases. Unless and until a client's instruction to buy or sell a security on the foreign exchange is successfully executed, no commission income is earned. And the greater the number of such successful transactions, the greater the amount of income generated. The profit in question is such income net of the transaction costs. The profit-producing transaction is therefore the successful execution of each trade. The same applies, so the Taxpayer submits, to placements and marketing income when the nature of such income is understood. To the extent that the Board's findings and the undisputed evidence do indeed support the conclusion that the disputed profits in each of the three categories were in fact so derived, the Taxpayer's case on geographical source will have been made out.

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<sup>27</sup> At 322.

<sup>28</sup> §9.

**D. Erroneous principles adopted by the Board**

45. The Board was not in any doubt as to the Taxpayer's case. It noted:

“The criterion used by the Appellant in classifying disputed income as offshore Hong Kong was based on the country in which the securities comprised in a client trade was listed and traded by customers of the Group. Income derived from execution of client trades of securities listed outside Hong Kong were classified as offshore and the subject matter of this appeal.”<sup>29</sup>

46. In addition to the well-known Hong Kong authorities, the Taxpayer cited the *Mehta* decision in support of its case. However, the Board sought to distinguish *Mehta* on the ground that the Privy Council was there only concerned with the profits derived from trades undertaken for the broker's own account whereas the present case concerns profits earned by the Taxpayer as a broker executing trades on behalf of its clients.<sup>30</sup> With respect, that is not a valid basis for distinguishing the *Mehta* case. As Lord Millett points out, while the judgment dealt for illustrative purposes with Mr Mehta's proprietary trades, the Privy Council was actually concerned with profits comprising both brokerage earned by him and the profits of his own trading.<sup>31</sup> In any event, there is no reason in principle for distinguishing between the two types of profit. Indeed, it was pointed out in the *Mehta* judgment that:

“To discriminate between *all kinds of profits* according to the place at which they accrue or arise is a plain dictate of the statute.” (emphasis supplied)<sup>32</sup>

The profit-generating transactions, whether in respect of trading profits or profits in the nature of brokerage, were those executed on the overseas exchange. If those transactions had not taken place, no profits of any description would have arisen.

47. The Board nevertheless reached the following conclusion:

“We reject the argument that the correct criterion for determination of the disputed incomes as offshore as being the place where the securities of client trades were executed. This is not supported by the Appellant's contention as to the importance of

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<sup>29</sup> Decision §20.

<sup>30</sup> Decision §19.

<sup>31</sup> See (1938) LR 65 Ind Appeals 332 at 341; and in the High Court, see AIR 1935 Bombay 423 per Beaumont CJ: “The assessee carries on business in Bombay as a broker in cotton, silver and other commodities, and he also, as a regular business, enters into contracts on his own behalf for the sale and purchase of such commodities ... During the year of assessment [in question] the assessee made a profit of Rs.11,54,830 from the business of buying and selling commodities outside British India, and the question is whether he is liable to be assessed in respect of this sum.”

<sup>32</sup> (1938) LR 65 Ind Appeals 332 at 350.

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both research and sales. The place of execution was an important factor but only one of several in this respect.”<sup>33</sup>

48. Earlier, the Board had stated:

“A body cannot be said to be fully functional without the brain. From a HK tax source of profit point of view, the place where a business was administered is certainly one factor which should be taken into consideration.”<sup>34</sup>

Use of a “brain” analogy or the place of administration of the business as criteria for ascertaining the geographical source of profits is plainly inconsistent with the decisions in *Mehta* and *Hang Seng Bank*. In a case like the present, source is determined by the nature and *situs* of the profit-producing transactions and not by where the taxpayer’s business is administered or its commercial decisions taken.

49. Having rejected the correct test, the Board went on to adopt a highly diffuse approach to what it called “relevant factors in the determination of the territorial source” of the income in question. First, emphasis was placed on the Taxpayer’s research and sales activities as a possible basis for holding that the disputed profits were sourced in Hong Kong:

“It would appear that given the emphasis of the Appellant on Research and Sales and the fact that Execution could be carried out by a third party subcontractor ..., the more important division which enabled the Group to earn Client Commissions was Research and Sales. ... Following on this logic, any Client commission earned by the Appellant from clients of the Appellant (in which the Appellant was the Group Contracting party) would primarily be earned by Sales, all other factors being equal. Thus any Client Commission earned by the Appellant from the Appellant’s clients in respect of client trades (irrespective of place of execution and settlement) would in all probability be sourced in Hong Kong fulfilling the 3 criteria of Section 14 of Cap 112.”<sup>35</sup>

50. Such an approach fails to focus on the transactions which proximately produce the profits and emphasises antecedent or incidental matters that, while commercially essential, are legally irrelevant. However impressive the client may find the Taxpayer’s research and sales service, in the absence of trades successfully executed abroad, no brokerage income arises. But quite apart from that objection in principle, the Board’s suggestion is at odds with the evidence. Thus, the evidence was that “... approximately two thirds of the Asian Agency Brokerage business of the Group was generated by sales effort in the London and New York offices.”<sup>36</sup> Moreover, the

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<sup>33</sup> Decision §124.

<sup>34</sup> Decision §63.

<sup>35</sup> Decision §122.a.

<sup>36</sup> Decision §74, referring to the testimony of Patrick Lawlor which was apparently accepted.

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Board found that the research “was undertaken by analysts based in each market” with the research publications then being “distributed to clients and ... used primarily by sales desks as reference and selling material stock.”<sup>37</sup> If two-thirds of the Group’s Asian agency business was generated by sales activities in London and New York using research generated by analysts working in the foreign markets in which the trades were effected, it is very hard to see how focusing on these as “factors” could lead to the conclusion that profits generated by those activities were sourced in Hong Kong.

51. The Board did not confine the indicia of geographical source to sales and research. It suggested, for example, that the “settlement” or “back office” operations might, if they accounted for a substantial part of the “expenses used to generate an income” be considered “a significant factor which should be taken into consideration when considering territorial source of that income”.<sup>38</sup> Indeed, the Board appeared to adopt an open-ended and speculative approach to factors which might bear on geographical source:

“There may be other considerations which were not in the evidence but which could be relevant or crucial in determining the source of any Client Commission which we have not seen. For example, the place of negotiations, signing, governing law and jurisdiction of the Agency Brokerage Contract may be important factors. A further example would be if the costs and expenses of the Settlements and/or Execution division of a foreign Group company responsible for settling the client trade constituted the majority of the expenses in a client trade and assuming that there were sufficient facts to conclude that this foreign Group company was acting as agent of the Appellant, then perhaps Execution and/or settlements was more crucial than Research and Sales as acts which earned the Client Commission. But these examples are unsupported by the evidence.”<sup>39</sup>

52. The apparent basis of its conclusion emerges near the end of the Decision in the following terms:

“We have a general idea from the evidence of the factors needed to determine this<sup>40</sup> in this case. Generality in this respect is insufficient to enable us to determine with certainty what are and are not the important acts and omissions of the Appellant which give rise to the profits in question. We are unable to conclude which are the more important things done or not done by the Appellant to earn the disputed profits.”<sup>41</sup>

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<sup>37</sup> Case Stated §17(ii).

<sup>38</sup> Decision §53.

<sup>39</sup> Decision §122.a.

<sup>40</sup> Whether the assessments were incorrect and/or excessive.

<sup>41</sup> Decision §127.



53. In other words, the Board apparently believed that in order to ascertain the source of the disputed profits, it had to investigate every facet of the Taxpayer's business<sup>42</sup> so that it could engage in a qualitative assessment of the relative importance of its various operations, choosing "the more important things done" towards the generation of those profits as the criteria for determining geographical source. That is not the approach mandated by the authorities and places an erroneous emphasis on matters properly regarded as antecedent or incidental to the profit-generating operations.

***E. The Board's misplaced complaints about insufficiency of evidence***

*E.1 Complaints based on a failure to apply the correct legal principles*

54. Given the Board's open-ended approach to ascertaining the source of profits, it is not surprising that it found many gaps in the evidence bearing on matters which it – erroneously – considered to be relevant.

*E.1 (a) Sales operations and client contracts*

55. One such area concerned the Group's sales operations involving clients of Group companies abroad whose orders were passed on to Hong Kong for execution on foreign markets. The Board complained that: "There is virtually no evidence on how clients became clients."<sup>43</sup> It also lacked evidence as to the identity of the company behind the London sales desk:

"For clients located in Europe, the Baring London office has an Asian sales desk which took the responsibility for European clients trading in Asian shares. But [Paul Snead] (and the evidence of the Appellant on the whole) did not tell us which Group company or companies were the employers or the principal behind this Asian desk in London."<sup>44</sup>

56. The Board complained repeatedly about knowing too little about the contract or contracts entered into by the overseas client:

"When the client would place a client order with a Barings sales desk, we have no idea whether the Baring sales desk was the Baring Group company with whom the client had a contract for the provision of the Agency Brokerage service (viz. the party legally obliged by contract to perform or arrange execution of a client order). We will refer to this entity as the 'Group Contracting Party'."<sup>45</sup>

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<sup>42</sup> Found to comprise the Research and Sales Division, the Execution or Dealings Division and the Settlements Division: Case Stated §§16-17.

<sup>43</sup> Decision §51.b.

<sup>44</sup> Decision §58.a.

<sup>45</sup> Case Stated §17(2)(vi).

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Expanding on this theme, it lamented:

“Due to the paucity of the evidence relating to what had transpired between the clients and the Group and the concentration of the evidence relating to execution and settlement, we have little idea of the relationship between the Group Contracting Party and its client and the relationship between various Group companies in the workflow relating to the receipt and passing on of client orders to the executing entity.”<sup>46</sup>

57. These complaints are misplaced. First, as previously indicated, the applicable legal principles direct the inquiry to address the nature of the transactions which produced the profits and where they took place – not matters antecedent or incidental to the profit-generating transactions. The creation of a customer relationship between the client and the overseas Group company’s sales desk is commercially essential and part of the causal chain leading to the possible execution of a trade in securities. But creation of the relationship is clearly not the profit-generating transaction, but merely antecedent in the aforesaid sense.

58. Secondly, the Board was in fact well-supplied with samples of customer account agreements, dealing tickets, trade confirmations, contract notes, settlement instructions and so forth, documenting the placing, execution and settlement of client trades.

59. Thirdly, the criticism lacks any forensic purpose or direction. Thus, it is said that the paucity of such evidence meant that the Board:

“...were not sure whether the Commission Income could be the commission paid by the client under an Agency Brokerage service provision contract or the commission paid to an executing entity or whether they were same. We were never sure to any degree whether the client was directed to pay the Client Commission to the Group Contracting Party which contracted with the client, to the Group company to which the sales desk of that client belonged or to the executing entity or the booking entity or to any other entity nominated by the Group.”<sup>47</sup>

60. But the evidence clearly establishes that commission paid by the client was credited to the Taxpayer’s bank accounts which were operated under power of attorney by the Baring entity in the overseas market where the trade was executed.<sup>48</sup> The profits declared by the Taxpayer represent the commission earned from the trades executed, net of expenses, including commission paid to the executing entity. The resulting figures and the status of those sums as profits of the Taxpayer’s business are agreed. There is therefore no need for and no relevance to the Board’s

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<sup>46</sup> Decision §75.

<sup>47</sup> Decision §75.

<sup>48</sup> As shown in the Table summarizing the evidence of sample documentation attached to and incorporated in the Decision by its §55, which I take plainly to represent a finding of fact by the Board. Samples of the powers of attorney were placed before the Board.

speculations as to what some further evidence might show in the context. Where, in any event, could such speculation lead? No one is seeking to suggest that the monies were not received by the Taxpayer or were not received for brokerage services rendered on the client's behalf or that they may have been paid for the account of some other Group company. If any of those speculative propositions were true, there would be no disputed profits to declare. The same can be said of the speculative Footnote (x) to paragraph 17 of the Case Stated.<sup>49</sup>

*E.1 (b) Evidence of Hong Kong operations*

61. Another irrelevant matter attracting the Board's criticism for want of evidence involved the Taxpayer's organizational structure in Hong Kong:

“What was conspicuously missing from the evidence was the specific organization structure of the Appellant itself. This would have been of great assistance to understanding the operations of the Appellant in Hong Kong and hence significant on the question of territorial source of profits of the Appellant.”<sup>50</sup>

62. This reverts to the error of reliance on the “brain analogy”. In fact, however, “[the] organization set-up of the Appellant's offices and departments in Hong Kong was the subject of cross-examination by Counsel for the Revenue”<sup>51</sup> involving an extensive investigation, among other things, of how overhead and other expenses for its operations in Hong Kong were allocated. Such evidence casts no light on the issue at hand and illustrates the how the Board misdirected itself as to the applicable principles.

*E.1 (c) Ignoring agreed facts*

63. As indicated in Section A of this judgment, the profits returned were significantly revised for the first three years of assessment. The total income declared for the years 90/91, 91/92 and 92/93 were initially in the respective total sums of \$59,200,800, \$57,345,081 and \$124,621,124. These were revised to the respective total sums of \$75,400,747, \$82,782,988 and \$149,671,124. Those latter amounts were formally agreed by the parties, as has been pointed out. The issue, as the parties submitted to the Board, concerned the portion (also upwardly revised) of those profits alleged by the Taxpayer to fall outside the charge as offshore profits.

64. The Board recorded that counsel for the Taxpayer:

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<sup>49</sup> “Footnote (x): When the Group Contracting Party (or its agent, the sales desk) directed the client order to the executing entity, what then is the relationship between the Group Contracting Party (either directly or indirectly through its agent, the sales desk) and the executing entity? ... Did the executing entity treat the Group Contracting Party (either directly or indirectly through its agent, the sales desk) as the principal or as the agent of the client in giving the buy/sell order? Whatever treatment was given, would this treatment be supportable in law?..”

<sup>50</sup> Decision §50.

<sup>51</sup> Decision §§106-108.

“... pointed out several misstatements of fact in the pre-Determination correspondence covering the first 3 tax years and submitted that this was due to the time that had passed and the change of personnel at the offices of both the Appellant and C&L. Further between 1990 to 1997, all the landmark ‘territorial source of profits’ cases were being decided.”<sup>52</sup>

65. However, that explanation was evidently not accepted and the fact that the figures were revised was regarded by the Board as undermining the credibility of the evidence presented by the Taxpayer, holding<sup>53</sup> that the inconsistency between the two sets of figures could not be ignored without evidence being called to explain the difference:

“To ask the Board to ignore presentations of facts prior to the Commissioner making a determination will require evidence that what was presented to the Revenue as facts by the taxpayer was presented in error with explanations and evidence as to why the error occurred. If such evidence were not presented, convincing reasons why such evidence could not be presented should be given. Otherwise, the credibility of the evidence presented to the Board in an appeal hearing which is contrary to prior presentations of facts would be severely tested.”<sup>54</sup>

66. This is a point of view which is difficult to understand. If a taxpayer makes a tax return which understates the profits earned, he can hardly be criticised for correcting it to declare the correct, upwardly-revised, amount of profits. The fact that the figures had to be revised can only relate to the quantum of profits earned in the years in question. And quantum was, as both parties informed the Board, agreed. It was agreed in the amounts set out in Section A above, in terms of the overall figures, their breakdown into the three categories of commission, placements and marketing income, and their further breakdown by country in which the transactions occurred, all those figures being set out in the Statement of Agreed Facts.

67. It is of course true that the figures said by the Taxpayer to represent the portion of its profits sourced offshore were also revised and were disputed by the Commissioner. But as the parties had again informed the Board, that dispute was one of principle relating to the criteria for ascertaining the geographical source of profits, not a dispute as to the credibility of the revised figures produced. Accordingly, I cannot accept the criticism regarding the absence of evidence to explain the reasons for the revision as any basis for holding that the Taxpayer has failed to discharge its onus.

*E.1 (d) Inconsequential criticisms*

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<sup>52</sup> Decision §42.c.

<sup>53</sup> Decision §43.

<sup>54</sup> Decision §44.

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68. Finally, attention may be drawn to criticisms regarding insufficiency of evidence which relate to wholly inconsequential matters or are entirely speculative and unwarranted. Two examples will suffice.

69. Referring to the point (among other things) as a “peculiarity”,<sup>55</sup> the Board stated:

“Appendix B2 ... showed an “Other” country for the Placements Income. Presumably it must mean some country(ies) other than those listed. But we fail to see why the country(ies) could not have been named.”<sup>56</sup>

This was regarded as an illustration of insufficiently detailed classification where “some income did not ‘fit’ the criterion”.<sup>57</sup>

70. Appendix B2, which is an annexure to the Statement of Agreed Facts, gives the country breakdown of the offshore income claim for the 92/93 year of assessment. It refers to income from transactions in Japan, Thailand, Singapore/Malaysia, Indonesia, Philippines, Taiwan, Korea and China as well as “Other”. The income dealt with in that table totalled \$68,054,000, while the income listed for “Other” was in the sum of \$6,000, stated to be placements income. In other words, it represented 0.009% of the income there dealt with. It is extraordinary that the Board considered it a matter of criticism that the Taxpayer failed to go into greater detail in relation to that item. Absence of such detail obviously has no impact whatsoever on the issue at hand.

71. The markets in which income was said to have been earned have been listed above. This is relevant to the second criticism by which the Board raised the suspicion that whole areas of income might not have been declared as part of the disputed profits:

“Curiously, client trades in securities listed in other major markets formed no part of the disputed income. This is peculiar since the criterion used by the Appellant was the stock exchange or market where the securities were traded. There was evidence presented to us stating that the Group acted for clients who traded in equity markets in the Far East, Latin America and other emerging markets. We could not see why this was limited to the various Asian markets mentioned above. What had happened to the client trades in securities in Latin America and other emerging markets?”<sup>58</sup>

72. A little later, the Board queried also the absence of information as to profits from trading on the London, American and Antipodean markets:

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<sup>55</sup> Decision §22.

<sup>56</sup> Decision §22.a.i.

<sup>57</sup> Decision §22.a.

<sup>58</sup> Decision §22.b.

“It appeared that the Group also traded in the London market as one of the Appellant’s witnesses was from the Group’s technology division and was adopting the automated client trade system in London for the Asian markets. Still further, there was mention of America, Austra (sic) and Europe in the breakdown for 93-94 ... and there was also mention of America, Europe, New Zealand/Australia in the products breakdown for 94-95...”<sup>59</sup>

The Board concluded:

“Therefore one would have expected the evidence to show trading of client orders in markets other than the Asian markets shown to us.”<sup>60</sup>

73. This apparently grave criticism regarding insufficiency of evidence is speculative and without substance. As the Board found,<sup>61</sup> the Taxpayer was part of the Baring group of companies depicted in a Chart which was annexed to the Decision. Evidence that “the Group” acted for clients who traded in equity markets in Latin America and other emerging markets is not evidence suggesting that the Taxpayer did so or that it had been remiss in providing evidence of such activities. The same applies to the Board’s comment that “the Group also traded in the London market”.

74. It is quite true that “mention” is made of “America, ‘Austra’ [evidently a spreadsheet contraction of “Australia”] and Europe” in the breakdown for 93-94” and of “America, Europe, New Zealand/Australia in the products breakdown for 94-95”. These are shown as Appendices B3 and B4 to the Statement of Agreed Facts. What the Board did not make clear was that they were “mentioned” only to provide the information that *zero* income was received by the Taxpayer from trading in such markets although certain expenses had been allocated, obviously as a matter of Group policy, to it in respect of trading done by the Group in those markets. In other words, the Taxpayer *did* tell the Commissioner and the Board what the position was regarding those markets and such information was, one emphasises again, formally agreed by the parties. If there had been income from trades executed in those markets, why should it be thought that the Taxpayer would not have given it exactly the same tax treatment as that given to trades effected on the Asian markets? The Board’s suspicion is wholly speculative and without foundation. It cannot have any bearing on discharge of the Taxpayer’s onus.

#### ***F. The Court of Appeal’s approach***

75. The Court of Appeal overturned Barma J’s judgment<sup>62</sup> and upheld the decision of the Board. Le Pichon JA, with whom the other members of the Court<sup>63</sup> agreed, described that

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<sup>59</sup> *Ibid.*

<sup>60</sup> *Ibid.*

<sup>61</sup> Case Stated §7. The Chart annexed to the Decision refers to over 50 companies.

<sup>62</sup> [2006] 2 HKLRD 6.

<sup>63</sup> Rogers VP and Stone J.

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decision as “admirable in its comprehensiveness and its detailed analysis of the evidence adduced”. Her Ladyship added:

“It dealt painstakingly and meticulously with each piece of relevant evidence, making pertinent and probing observations which revealed the logic behind the Board’s thinking and conclusions.”<sup>64</sup>

It will be obvious from the earlier part of this judgment that that is an encomium to which I am regretfully unable to subscribe.

76. Le Pichon JA noted that “the central question for the Board was to determine the acts or operations of the Taxpayer which produced [the relevant] profits”.<sup>65</sup> However, in approaching that question, the Court of Appeal was evidently in agreement with the diffuse approach adopted by the Board which, as indicated above, is in my view erroneous. Thus, her Ladyship pointed to the Taxpayer having modified its case on appeal,<sup>66</sup> referred to the Board’s dissatisfaction with the paucity of the evidence relating to the client’s relationship with the various companies in the Group<sup>67</sup> and added:

“When it was incumbent on the Taxpayer to satisfy the Board as to the source of its profits, could the Board realistically be faulted for wanting evidence to explain the contractual or other relationship giving rise to the Taxpayer’s entitlement to the income? Put differently, assuming the Taxpayer was not the Group Contracting Party, even if the funds had been channelled from the client of the Group Contracting Party through it to the execution office situated offshore, why was it that part of those funds became the Taxpayer’s income? What services had it performed to earn that income?”

77. These are, with respect, misdirected questions. The queries raised in the passage quoted have lost sight of the parties’ agreement that the amounts stated in the tax returns were the Taxpayer’s income. Presumably the Taxpayer would have been only too pleased to provide evidence to the contrary if its case was that the funds were not its income. However, as discussed in the section which follows, the evidence and the Board’s own findings establish the services performed by the Taxpayer to earn that income.

78. At first instance, after considering the authorities, Barma J concluded (in relation to commission income) as follows:

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<sup>64</sup> Judgment §22.

<sup>65</sup> Judgment §23.

<sup>66</sup> Judgment §21.

<sup>67</sup> Judgment §24, citing Decision §75.

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“While there may well have been other functions that [the Taxpayer] 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.”<sup>68</sup>

As I have previously indicated, I consider this to embody in principle the correct approach in the present case.

79. The Court of Appeal obviously did not agree. Le Pichon JA criticised Barma J in this context stating:

“As the judge recognised, correctly in my view, the central question for the Board was to determine the acts or operations of the Taxpayer which produced those profits. However, as will become apparent, in the course of his judgment, the judge shifted his focus, lost sight of the central question and ended up adopting the approach which had been advocated by Mr Barlow and which he had professed to reject, namely by focussing on the transactions which produced the profit to the Taxpayer rather than the acts and operations of the Taxpayer itself which generated the profits.”<sup>69</sup>

80. With respect, I consider this criticism to be unjustified and to involve a misreading of Barma J’s judgment. The passage just cited draws a dichotomy between “the transactions which produced the profit to the Taxpayer” and “the acts and operations of the Taxpayer itself which generated the profits”. But there is, in the present context, no inconsistency between the two. If, on the evidence, the offshore transactions effected by the Taxpayer (through foreign brokers) were the relevant profit-generating transactions, then they were the Taxpayer’s “acts and operations” which produced the profits.

81. Where Barma J had disagreed with Mr Barlow was in respect of the latter’s submission that “when dealing with the position of a group of companies, it is appropriate ... to have regard to the group as a whole”.<sup>70</sup> It was a rejection of Mr Barlow’s submission that passages in the authorities which “were couched in less personal terms” permitted such an approach.<sup>71</sup> The Judge pointed out that Lord Jauncey<sup>72</sup> “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.*” These italics are mine, but in citing from Lord Jauncey’s speech,<sup>73</sup> Barma J supplied the italics to stress that it was the operations of the taxpayer which were relevant. He emphasised again in the next paragraph that the test should “be understood as directing the inquiry to the operations of the

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<sup>68</sup> Judgment §42.

<sup>69</sup> Judgment §23.

<sup>70</sup> Judgment §30.

<sup>71</sup> Judgment §26.

<sup>72</sup> In *Commissioner of Inland Revenue v HK-TVB International Limited* [1992] 2 AC 397.

<sup>73</sup> At 411B.



taxpayer, rather than the operations of others.”<sup>74</sup> I therefore do not accept that he shifted his position. Instead, I consider his Lordship to have applied to correct legal test.

**G. Commission income**

82. If the Board had applied the correct legal principles, it could have been expected to examine the material evidence concerning execution and settlement of the transactions said to have given rise to the disputed profits, considered whether such evidence was sufficient to discharge the Taxpayer’s onus and then neatly made the necessary findings. But, as we have seen, it rejected the correct test and substituted an open-ended, diffuse test which is contrary to authority, and concluded that the evidence was insufficient to discharge that onus.

83. One approach might be to remit the matter to the Board to have another go on the basis of the correct principles. But the years of assessment in question date back to 1990/1991. The Determination is dated 31 July 1997 and the Board hearing took place in July 2000, with its decision delivered on 8 February 2002, some 19 months later. The Case Stated is dated 6 February 2003 and, having traversed the Court of First Instance and the Court of Appeal, we are now in the summer of 2007, some 16 years after the first year of assessment in question and seven years after the Board’s hearing. In such circumstances, I recoil from the idea of a remitter. The alternative, which is the approach I propose to adopt is, after removal of the encrustations of irrelevance, to examine the evidence and the findings to see whether they provide a sufficient basis to resolve what is, after all, a narrow issue: that of geographical source. That is indeed the approach which Barma J appears to me to have adopted and I do not think it justified for such approach to be criticised as “assum[ing] the Board’s fact-finding role”<sup>75</sup> or as “embark[ing] upon a reclassification of the facts and substitution of his own conclusions as to the establishment of a ‘prima facie case’”<sup>76</sup>.

84. It is against this background that I turn to consider the sufficiency of the evidence and the Board’s findings in relation first to the category of disputed profits involving commission income.

85. The Taxpayer was part of an international financial group whose clients in various countries would from time to time place orders to trade in securities on certain Asian markets. They would approach the “sales desk” of the relevant Baring company, usually in the country of the client’s residence. Their orders would be channelled to the Taxpayer who would execute them at the relevant stock exchange through a broker, which might or might not be a Baring entity, trading on the relevant Asian market. The Taxpayer would act as counterparty to the executing broker and receive payment from the client in the Taxpayer’s bank account for any purchases of securities as well as the associated commission. From those sums, the Taxpayer would pay the expenses of the transaction, including the executing entity’s commission. The net commission it retained would constitute its profit.

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<sup>74</sup> Judgment §28.

<sup>75</sup> Per Le Pichon JA at §28.

<sup>76</sup> Per Stone J at §38.

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86. In my view, the Board's findings taken in the context of the undisputed evidence sufficiently establish the facts referred to in the preceding paragraph, providing a valid basis for ascertaining the source of the profits arising from the commission income:

(a) Having defined "Client" as the client of the Group or one of its companies, including the Taxpayer, the Board defined "Client order" as "instructions from a client to any Group company to buy or sell certain securities listed or about to be listed on any major global stock exchange."<sup>77</sup>

(b) The Board then described how client orders were passed on to and executed by the Taxpayer:

"The passage of client orders in the Group took place as follows. The workflow commenced at the point where the sales desks, having received the client orders, passed on the client orders to the Taxpayer or the Group company located in the market of the securities to be traded. The evidence suggested either (i) the client orders for securities to be traded in the Asian markets were passed on by the sales desks to the Taxpayer which were then passed on to the relevant Group company located in or near the market of the securities to be traded or (ii) client orders were passed simultaneously or nearly contemporaneously to the Taxpayer and the relevant Group company located in or near the market of the securities to be traded. The relevant Group company located in or near the market of the securities to be traded would then execute the client trade if it were an executing entity or it would ensure that a third party executing entity would execute the client trade in the market."<sup>78</sup>

(c) In particular, the Taxpayer's role in this process was described as follows:

"It received client orders originating from outside the Asian Pacific region in respect of securities traded in Asian Pacific markets and passed them on to the relevant executing entities in the relevant markets (sometimes through another Group company in the region). It provided services to Hong Kong clients for trading of foreign securities."<sup>79</sup>

(d) The Board annexed to its Decision a Table summarizing the sample documentation "relating to the execution and settlement of client trades in various Asian markets". As noted above, such sample documentation provided to the Board included dealing tickets, trade confirmations, contract notes, settlement instructions and the like.

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<sup>77</sup> Case Stated §17(1)(iii) and (iv).

<sup>78</sup> Case Stated §18.

<sup>79</sup> Case Stated §21.

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- (e) The Table contained certain comments and queries by the Board but, save where the query indicates a factual difficulty which would prevent a finding being made, it is in my view clear that it was intended to represent a summary of the evidence which the Board accepted relating to way in which client trades were executed and settled although, as pointed out above, given the legal test adopted, the Board did not rest its conclusion on such findings. I respectfully disagree with Le Pichon JA's view that the Table does not contain findings of the Board.<sup>80</sup>
- (f) It is clear from the Table that settlement was effected by the clients paying the necessary commission (as well as the price of securities purchased, if the order was for a purchase) into a bank account maintained by the Taxpayer in the country in question, operated under power of attorney by the Baring entity there located. Samples of such powers of attorney were placed before the Board.
- (g) In the Appendices to the Statement of Agreed Facts, the figures showing the breakdown of income from transactions on the foreign markets were stated to represent "Net offshore commission income", that is, the net amounts retained after paying the expenses of the transactions.
- (h) As the Board noted, according to information supplied by the Taxpayer's tax representatives: "Commission was the difference between the commission charged to clients by the Appellant and the commission charged by overseas brokers to the Appellant". This was relied on by the Board in distinguishing between commission income and marketing income.<sup>81</sup>

87. In my judgment, the findings and evidence (which was agreed or effectively indisputable) justify the conclusion, applying the legal principles discussed above, that what the Taxpayer did to earn the commission income was to execute client orders on foreign stock markets. The profit-generating transactions were the successful trades in question, effected abroad, so that the profits produced did not derive from Hong Kong. Execution of those transactions was the essential condition of earning the relevant profits and the volume of those transactions determined the amount of profits generated. This was accurately expressed by Barma J as follows:

"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

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<sup>80</sup> Court of Appeal Judgment §28.

<sup>81</sup> Decision §81.

the service for which the client of the sub-group pays the commission which it is charged.’<sup>82</sup>

#### **H. Placements income**

88. The Taxpayer’s figures showing the placements income generated each year were agreed, as noted above. As to the nature of such income, the Board found that it “appeared to be related to the commissions earned from clients in the purchase of new shares issued or to be listed outside Hong Kong”. Notwithstanding the words “appeared to be”, it is reasonable to treat this as a finding of the Board as it is consistent with other findings made in this context (as discussed below). On this basis, the profits deriving from placements income are little different from those deriving from commission income. The difference is that in the case of placements income, the client’s instructions were to purchase shares which were about to be issued.

89. This is reflected in a number of the Board’s findings. Thus, as we have seen, it defined “Client Order” to include “instructions from a client to any Group company to buy or sell certain securities listed or *about to be listed* on any major global stock exchange.”<sup>83</sup> In describing the Taxpayer’s business, the Board stated that it and members of its Group “were securities brokers trading securities listed *or to be listed* in the various major global stock markets for and on behalf of clients of the Appellant and the Group.”<sup>84</sup>

90. At one point in the Decision, the Board appeared to be calling into question the true nature of placements income, suggesting that it was not clear if it was different from sub-underwriting commission. Although not articulated, the Board might have had it in mind that if such income in fact represented sub-underwriting commission or fees payable to the Taxpayer by a lead underwriter pursuant to a sub-underwriting contract performed by the Taxpayer in Hong Kong, rather than commission earned by the Taxpayer acting as a broker for clients, then placements income – if in fact sub-underwriting commission or fees – might properly be found to be sourced in Hong Kong. This was a doubt which derived from a Coopers & Lybrand letter to which I will return. The Board stated:

“In C&L’s letter to the Revenue dated 14th April 1994, the ‘Commission earned on Placements and New Issues’ was described by C&L as ‘sometimes be (sic) called sub-underwriting Commission’. Thus it is not clear whether this Sub-underwriting Commission is the same as or different from the 1st category of disputed offshore income called Placements Income described below. Unfortunately this point was not spotted at the hearing of the appeal and the parties had no opportunity to make submissions on this.’<sup>85</sup>

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<sup>82</sup> Barma J, §38.

<sup>83</sup> Case Stated §17(1)(iv).

<sup>84</sup> Decision §16.

<sup>85</sup> Decision §42.f.

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91. It is a pity that the parties were not asked to make submissions to clear up this matter. It seems plain that any such doubts could readily have been dispelled.

92. In the first place, a distinction was drawn by the Taxpayer throughout between offshore income which included placements income and “offshore sub-underwriting commission” which was always shown as a separate category of income. The two categories are distinctly set out in its profits tax returns, in both the original and revised versions, as appears from the tables reproduced in Section A of this judgment. The assessor charged tax on sub-underwriting commission separately from the charge on the disputed profits each year.<sup>86</sup> The objection lodged by Coopers & Lybrand was against the charges levied on “commission from placements of securities listed in overseas markets” and not on sub-underwriting commission.<sup>87</sup> And the Commissioner, in his determination, upheld the assessments treating the different charges separately.<sup>88</sup>

93. Secondly, the nature of placements income as “commission earned on placements and new issues” pursuant to “orders received from [Baring Group] clients” was consistently the way such income was explained in pre-Determination correspondence, as the Board recorded:

“The Placements Income was submitted to be commission earned on placements and new issues of securities on overseas stock exchanges in Indonesia, Singapore, Malaysia, Philippines, Taiwan and People’s Republic of China. According to the Pre-determination correspondence of C&L, Baring Group offices all over the world would refer orders received from their clients to the Appellant. The Appellant consolidated the orders (including those from Hong Kong clients) and transmitted these orders to the overseas locations for execution (C&L letter dated 19th November 1991 and 14th April 1994). There was no agreement between Baring overseas offices and the Appellant. Allocation of commission to the Appellant was a matter of group policy. No commission was payable unless a transaction occurred (C&L letter dated 16th April 1992). C&L provided a Schedule of the offshore placements and new issues commissions for the year 1990/91 breaking down the offshore commission derived from Hong Kong and overseas clients (as Schedule D of the Determination).”<sup>89</sup>

Two important points should be noted. First, as with commission income transactions: “No commission was payable unless a transaction occurred.” Next, a breakdown of placements income “derived from Hong Kong and overseas clients” (and not from any lead underwriter) was provided and annexed to the Determination.

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<sup>86</sup> Statement of Agreed Facts §8.

<sup>87</sup> Statement of Agreed Facts §9.

<sup>88</sup> Statement of Agreed Facts §10.

<sup>89</sup> Decision §82.

94. Thirdly, Paul Snead gave evidence in relation to placements income, as the Board recorded:

“PS also described the process of how the Appellant was involved. ‘ At the time of new issue or placement in markets in the Asian region, the Appellant would generate orders itself from Hong Kong clients and receive orders referred from Group offices worldwide and would pass on orders for execution to the Group regional company where the security was being issued. The Appellant would receive a commission for the successful placement of the overseas issue with an overseas client.’ ”<sup>90</sup>

95. The evidence and findings therefore all point, so far, in the same direction. They indicate that placements income is merely a form of commission earned upon the successful execution on a foreign stock market of purchase orders relating to securities about to be issued in that market. On this basis, such income ought to be regarded as sourced where the transaction is successfully executed – outside Hong Kong. The only remaining question relates to the C&L letter of 14 April 1994 which sparked this discussion.

96. Three paragraphs of the letter are material and are reproduced as follows:

“6. The offshore commission income falls into three categories:-

- Commission earned on placement and new issues (this has sometimes be[en] called sub-underwriting commission)
- Commission
- Marketing income and expenses.

*Commission Earned on Placements and New Issues*

7. The commission was earned on the purchase, for clients, of shares in new issues and/or placements in overseas markets, namely Indonesia, Singapore, Malaysia, Philippines, Taiwan and People’s Republic of China.

8. At the time of a new issue and/or placement in these markets, other Baring Group offices around the world would refer orders received from clients to [the Taxpayer]. [The Taxpayer] would consolidate the orders received (including those received from Hong Kong clients) prior to transmitting them to the overseas locations for execution. The commission received represents

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<sup>90</sup> Decision §84. The Board complain that their attention was not drawn to documents in the bundle relating to placements income, but they do not suggest that they rejected Mr Snead’s evidence.

income accruing to our client from the execution of the transactions outside Hong Kong and, as such, is not subject to Hong Kong profits tax.”

97. In my view, it is clear beyond peradventure that the reference to “placements income” having sometimes been called “sub-underwriting commission” is entirely inconsequential. It is in an introductory paragraph which identifies the three categories of disputed profits. When, in paragraphs 7 and 8, the letter proceeds to explain what placements income actually consists of, no room is left for doubt: it consists of commission earned from clients for execution of offshore purchase orders for the acquisition of new issue shares in a foreign market.

98. It is accordingly my view that the unquestioned evidence and findings of the Board amply support the conclusion that such income is sourced offshore and falls outside the charge to Hong Kong profits tax.

#### ***I. Marketing income***

99. The Board’s discussion of marketing income was unfortunately somewhat side-tracked by a preoccupation with the somewhat peripheral question of whether it differed from commission income. As will emerge shortly, it seems clear that there are material differences between the two categories of income. The important questions relate to the nature of marketing income and whether it is in law to be regarded as sourced abroad.

100. The Board noted that on the Taxpayer’s evidence:

“Marketing income was the result of the Baring group policy of splitting commission between the parties executing the transaction and introducing the clients. Marketing income was the Appellant’s share of the commission earned by the overseas broker while Marketing expense was commission paid by the Appellant to a fellow group company for introducing the client to the Appellant.”<sup>91</sup>

101. In other words, such income was the product of agreements (referred to as Commission Agreements) reached between companies in the Group whereby one such company, such as the Taxpayer, which introduced a client to another Group company operating in a foreign market, with a view to that client effecting trades on that market through that other Group company, would receive a share of the commission earned from resultant transactions executed by the other Group company for that client on the foreign market.

102. The Taxpayer placed six such Commission Agreements before the Board as evidence of the arrangements entered into. Their terms were considered in some detail by the

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<sup>91</sup> Decision § 88.c.ii.

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Board which noted that some variation in such terms existed.<sup>92</sup> Nevertheless, the essential qualities of the agreements were as pointed out in the preceding paragraph.

103. Thus, for instance, a Commission Agreement dated 1 October 1990 between the Taxpayer and Baring Securities (Japan) Ltd stated that it had been entered into to “determine the basis for calculating the commission receivable by one party in respect of business introduced by it to the other.”<sup>93</sup> The parties agreed “that if one party (‘the introducing party’) introduces business to the other party (‘the booking party’), the booking party shall pay the introducing party a commission in accordance with [a specified] scale of commissions.” It was an agreement that worked in both directions, that is, in respect of clients introduced by either party to the other. It stipulated that where introduction of a client resulted in transactions in Japanese equities, the “booking party” (in this case, the Japanese company) would pay 50% of the net retained commission to the introducing party.

104. The Board noted the gist of these agreements:

“Commission earned from clients was shared between an introducing party and a booking party at 50% of the net retained commissions for transactions on Japanese, Hong Kong, Philippine and Indonesian equities. The booking party [that is the party to whom the client was introduced] was to pay the introducing party.”<sup>94</sup>

105. Pursuing its concern with the differences between commission income and marketing income, the Board embarked<sup>95</sup> on a complicated discussion which it is not necessary to examine. There is, to my mind, undoubtedly a difference in how each of the two categories of income was generated. Commission income refers to the profit derived from commission paid by the client to the Taxpayer, net of expenses, for transactions executed by the Taxpayer on the client’s behalf in a foreign market. Marketing income is paid to the Taxpayer pursuant to the terms of a Commission Agreement by the other Group company which has earned commission paid by the introduced client for executing that client’s orders on the foreign market. What the Taxpayer does to earn the marketing income is therefore quite different. It does not execute the client’s orders through a foreign broker and is not a counter-party to that trade. It introduces the client to the foreign Group company and, pursuant to a contract entered into between the two companies, it shares in the commissions earned from resultant transactions executed for the introduced client on the foreign market.

106. The geographical source in relation to this category of the Taxpayer’s profits is not as clear-cut as with the other two categories. However, in my view, applying the abovementioned legal principles, marketing income must also be regarded as sourced outside of Hong Kong. What

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<sup>92</sup> Decision §109. The Korean arrangement in particular involved peculiarities that need not detain us.

<sup>93</sup> Decision §109(b)d.

<sup>94</sup> *Ibid.*

<sup>95</sup> Decision §§110-115.



the Taxpayer has done to earn its share of the offshore commissions received is to introduce its client to the foreign Group company, which introduction takes effect as a profit-generating transaction only when that client enters into a relationship with that overseas company and instructs it to execute transactions on the foreign market. Only then are commissions to be shared with the Taxpayer generated. They are paid to the Taxpayer in performance abroad of the foreign party's obligations under the Commission Agreement.

107. Before leaving this discussion of marketing income, I ought to say something about *Commissioner of Inland Revenue v Wardley Investment Services (Hong Kong) Ltd.*<sup>96</sup> It was a case where rebated commissions (including commissions rebated by brokers trading on foreign markets) earned by the taxpayer were held to be sourced in Hong Kong. It was therefore a case which has a factual resemblance to the present, involving the sharing of commissions earned by foreign brokers. However, that resemblance is superficial and that case is, in my view, clearly distinguishable and of no direct application.

108. *Wardley* did not involve the Hong Kong taxpayer making any introduction of a client to a broker on a foreign securities market with a view to that broker enjoying that client's business on that market. In *Wardley*, the taxpayer was carrying on business in Hong Kong as an investment adviser pursuant to a management agreement whereby it was to invest clients' funds in a fiduciary capacity<sup>97</sup> with a contractual entitlement to fees representing a percentage of the value of the funds under management as well as the contractual right to receive any commission rebates it managed to negotiate with brokers which it employed on behalf of the clients.

109. The contest was between two possible views as to source. The Commissioner's argument, distinguishing the *Mehta* case discussed above, was that:

“... the rebate commissions ... were not earned from the actual trading on the stock markets overseas but from rendering services under the investment agreement and in return the Taxpayer was given or allowed to keep the rebate commissions.”<sup>98</sup>

110. The board took the contrary view, holding that the source was offshore :

“What the Taxpayer was receiving was an actual share of the overseas agents commission. Clearly the overseas agent earned its commission overseas. It cannot be suggested for one moment that the overseas agent is taxable in Hong Kong on the fees which it earned. The agreements between the Taxpayer and its overseas agents were to share in the gross profits, that is, commissions which the overseas agents made on the business offered to the overseas agents by the Taxpayer.”<sup>99</sup>

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<sup>96</sup> (1992) 3 HKTC 703.

<sup>97</sup> It was to “invest the funds placed by the customer with the Taxpayer as though the Taxpayer were the beneficial owner of such funds” (at 705).

<sup>98</sup> At 710.

<sup>99</sup> At 713.

111. The board was reversed by Godfrey J and by the majority in the Court of Appeal, essentially along the lines advocated by the Commissioner. Fuad VP held:

“The Taxpayer was carrying out its contractual duties to its client and performing services under the management agreement in Hong Kong and in return receiving the management fee as well as the ‘additional remuneration as manager’ to which it was entitled under that agreement. In my view, 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 transaction which earned the broker a commission.”<sup>100</sup>

112. I respectfully consider *Wardley* to have been correctly decided. The taxpayer was acting as a fiduciary in investing its clients’ funds. The sole basis upon which it was entitled to receive and keep for itself a negotiated rebate on commission paid to effect trades on its clients’ behalf was the management agreement which it was performing in Hong Kong. It would otherwise have come under a duty to account to the clients for the rebated sums which represented a reduction in the expenses incurred in effecting trades on clients’ behalf. What produced the profit was therefore performance of the contract in Hong Kong and not the effecting of the trades offshore.

### ***Conclusion***

113. For the foregoing reasons, I agree with Lord Millett that all the disputed profits arose or derived from outside Hong Kong and were therefore not chargeable to profits tax in Hong Kong. I too would allow the appeal, set aside the Order of the Court of Appeal and order that the assessments for each of the relevant years be reduced by excluding the disputed profits. I agree that costs should be dealt with by written submissions and would also like to associate myself with the remarks of Mr Justice Bokhary PJ and Mr Justice Chan PJ as to the desirability of providing for professional full-time Board of Review panels to deal with the more complex and burdensome appeals.

### **Mr Justice Nazareth NPJ:**

114. I have had the advantage of reading in draft the judgments of Mr Justice Ribeiro PJ, Mr Justice Chan PJ and Lord Millett NPJ. I agree with their conclusion that the appeal must be allowed for the reasons they give.

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At 729.

115. I have also had the advantage of reading in draft the judgment of Mr Justice Bokhary PJ. I agree with his observations and views, and those of Mr Justice Chan PJ, on the composition and operation of the Board of Review.

**Lord Millett NPJ:**

116. The question for decision in this appeal is whether profits made by the Taxpayer in the relevant years of assessment (1990/1991 to 1994/1995) which were derived directly or indirectly from transactions in securities traded or intended to be traded on stock exchanges outside Hong Kong were nevertheless subject to Hong Kong profits tax as profits “arising in or derived from Hong Kong”.

***The Taxpayer’s business***

117. The Taxpayer was incorporated in Hong Kong in 1984. It carried on the business of agency brokerage in Hong Kong as a member of a multinational group of companies which carried on a global business in many different countries. At all material times it was a wholly owned subsidiary of Baring Securities Ltd (“BSL”), itself a wholly owned subsidiary of Baring Brothers & Co. Ltd which was a long established merchant bank in London. BSL and its subsidiaries formed the group’s securities trading arm. The Taxpayer was one of 23 sub-subsidiaries of BSL. Other companies in the Asian region were located in Indonesia, the Philippines, Singapore (which also had an office in Kuala Lumpur), Japan, and Taiwan. There was no subsidiary in the PRC or Thailand. For brevity I shall refer to the BSL sub-group as “the Barings group”, though it was in fact only part of a much larger group of companies bearing the name “Barings” as part of their title.

118. The Barings group carried on an agency business, that is to say it acted exclusively for clients and earned commission by carrying out their instructions. The clients consisted mainly of financial institutions, hedge funds, fund managers, and a small number of high net worth individual investors. They were attracted to place their business with the Barings group by the quality of its research and advice, and no doubt by the name Barings and the high reputation which then attached to it. The Taxpayer acted for clients in Hong Kong which wished to deal in securities listed or intended to be listed on a stock exchange whether in Hong Kong or elsewhere in Asia; but it also acted on the instructions of other members of the Barings group given on behalf of clients outside Hong Kong which wished to deal in such securities. Where the Taxpayer was authorised to deal on the relevant stock exchange, it carried out the transaction itself. Where it was not authorised to do so, it instructed local stockbrokers to carry out the transaction or (more usually) asked the Barings subsidiary in or near the place of execution to place the order on its behalf.

119. In its tax returns for the relevant years the Taxpayer separated its trading profits derived from transactions executed in Hong Kong from other profits (“the disputed profits”) which it claimed arose in or were derived from outside Hong Kong. It offered up for assessment and was assessed on its profits from transactions in securities on the stock exchange in Hong Kong. The disputed profits arose from commissions earned directly or indirectly from transactions in securities

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listed and placements of securities intended to be listed on other Asian stock exchanges, viz. stock exchanges in Japan, Thailand, Singapore, Malaysia, Indonesia, the Philippines, Taiwan, Korea and the PRC. The Commissioner rejected the Taxpayer's contention that the disputed profits "arose in or were derived from" outside Hong Kong and assessed it to tax on these profits also. The Taxpayer appealed to the Board of Review against this part of the assessment.

120. In the Agreed Statement of Facts which was before the Board of Review the Taxpayer distinguished between the amounts of the disputed profits attributable to (i) commissions; (ii) placements; and (iii) what it described as "marketing". It did not, however, distinguish between profits earned by acting on behalf of clients in Hong Kong and profits earned by acting on the instructions of other members of the Barings group given on behalf of overseas clients. Its case was that, whatever the source of its instructions and wherever the ultimate client was resident, the critical feature which took the disputed profits out of Hong Kong tax was that they arose or were derived directly or indirectly from transactions which took place outside Hong Kong.

### *The course of the proceedings*

121. The hearing before the Board of Review took place on 13, 14, 17 and 18 July 2000. After an unexplained and to my mind unacceptable delay of 19 months the Board of Review delivered its Decision on 8 February 2002. It concluded that the Taxpayer had not discharged the burden of proving that the assessments were wrong. On 6 February 2003 the Board of Review stated a case for the opinion of the High Court. I shall have more to say later about the form and contents of the Decision and the Stated Case, of which I count myself fortunate never to have seen the like. It is sufficient for the moment to say that they make it extremely difficult to extract the Board's findings of primary fact.

122. By his judgment dated 1 June 2005 Barma J allowed the Taxpayer's appeal, but his judgment was reversed by the Court of Appeal (Rogers VP, Le Pichon JA and Stone J) with reasons given on 20 June 2006. The Court of Appeal, which rejected the Taxpayer's criticisms of the Board of Review's Decision, held that the judge, having stated the correct test for determining the source of the Taxpayer's profits, then lost sight of it and applied the test for which the Taxpayer had contended and which he had himself earlier rejected. The Court of Appeal also held that the judge's approach was "seriously flawed". Not only had he failed to adopt the Board of Review's findings of fact as a starting point, but he appeared to have assumed its fact-finding role himself. It is only fair to state at once that for my part I would reject both these criticisms of the judge.

### *The Ordinance*

123. Section 14 of the Inland Revenue Ordinance, Cap.112 provides:

"(1) ... profits tax shall be charged 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* for that year from such trade, profession or business ...” (emphasis added).

***The relevant legal principles***

124. Before turning to the decisions below, it is convenient to set out, necessarily at some length, the relevant legal principles to be applied in determining the geographical source of a taxpayer’s profits.

(i) *The broad guiding principle*

125. The principles which are applicable to the determination of the source of trading profits for the purpose of s.14 have been considered in three modern decisions of the Privy Council, viz. *Commissioner of Inland Revenue v. Hang Seng Bank* [1991] 1 AC 306 (“*Hang Seng Bank*”); *Commissioner of Inland Revenue v. HKTVB International Ltd* [1992] 2 AC 397 (“*HKTVB*”); and *Commissioner of Inland Revenue v. Orion Caribbean Ltd* [1997] HKLRD 924.

126. In *Hang Seng Bank* Lord Bridge said at pp 318 E-F and 319B:

“... 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. ...

...

It follows that a distinction must fall to be made between profits arising in or derived from Hong Kong (‘Hong Kong profits’) and profits arising in or derived from a place outside Hong Kong (‘offshore profits’) according to the nature of the different transactions by which the profits are generated ...”

As this passage shows, the place where the business is carried on is not necessarily the place where the profits arise.

127. Lord Bridge later gave what he described as “the broad guiding principle” to be adopted for determining the geographical source to which income or profits should be ascribed. At pp 322-3 he said:

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“Their Lordships were referred in the course of the argument to many authorities on different taxing statutes in different common law jurisdictions raising a variety of questions as to the geographical source to which income or profits should be ascribed. 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 ...” (emphasis added).

128. In *HKT VBI* (at p407A-C) Lord Jauncey attributed the origin of Lord Bridge’s “broad guiding principle” to the judgment of Atkin LJ in *F.L. Smidth & Co. v. Greenwood* [1921] 3 KB 583 at 593 where he had said:

“I think that the question is, where do the operations take place from which the profits in substance arise?”

Immediately after citing that passage, Lord Jauncey said:

“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.’”

And at p.411 he said that the fundamental question was:

“... what were the operations of the taxpayer which produced the relevant profit?”

129. Lord Jauncey was plainly not intending to enunciate a different test from that stated by Atkin LJ. The operations “from which the profits in substance arise” to which Atkin LJ referred must be taken to be the operations *of the taxpayer* from which the profits in substance arise; and they arise in the place where his service is rendered or profit-making activities are carried on. There are thus two limitations: (i) the operations in question must be the operations of the taxpayer; and (ii) the relevant operations do not comprise the whole of the taxpayer’s operations but only those which produce the profit in question.

130. The principles governing the determination of this question were revisited by this Court in *Kwong Mile Services Ltd v. Commissioner of Inland Revenue* (2004) 7 HKCFAR 275. Mr Justice Bokhary PJ observed at p.283 that Lord Bridge’s broad guiding principle was not

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intended to be a universal test for ascertaining the source of profit. Nor would attempting to formulate such a test be wise. He said that:

“... The situations in which the source of a profit has to be ascertained are too many and varied for a universal judge-made test. Apart from the words of the statute themselves, the only constant is the need to grasp the reality of each case, focusing on effective causes without being distracted by antecedent or incidental matters.”

131. It is well established in this as in a number of other jurisdictions that the source of profits is a hard practical matter of fact to be judged as a practical reality. It is, in other words, not a technical matter but a commercial one.

132. Before us the Taxpayer has repeated the submission made before Barma J that, while it was ordinarily sufficient to look at what the taxpayer had done to earn the profit, that was not so where it traded as a member of a group. In such a case, it was said, the “effective causes” which generate the profit may lie in the activities of other members of the group, and focusing exclusively on the operations of the taxpayer to the exclusion of the operations of its associated companies could lead to a conclusion at variance with commercial reality.

133. Barma J rightly rejected this submission. He observed that the authorities directed the court to a consideration, not of the operations which produced the profits in question (as Atkin LJ’s formulation with its omission of any reference to the taxpayer might suggest), but more narrowly of the operations of *the taxpayer* which produced them. As Barma J observed, Lord Bridge, no less than Lord Jauncey, referred to “what *the taxpayer* has done to earn the profit in question”.

134. Before the recent decision of this Court in *Kim Eng Securities (Hong Kong) Ltd v. Commissioner of Inland Revenue* [2007] 2 HKLRD 117 (“*Kim Eng*”), where the same test was applied, the cases were concerned with taxpayers which were independent companies and not part of a group. But I cannot accept the proposition that, in the case of a group of companies, “commercial reality” dictates that the source of the profits of one member of the group can be ascribed to the activities of another. The profits in question must be the profits of a business carried on in Hong Kong. No doubt a group may for some purposes be properly regarded as a single commercial entity. But for tax purposes in this jurisdiction a business which is carried on in Hong Kong is the business of the company which carries it on and not of the group of which it is a member; the profits which are potentially chargeable to tax are the profits of the business of the company which carries it on; and the source of those profits must be attributed to the operations of the company which produced them and not to the operations of other members of the group.

(ii) Agency

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135. In *Kim Eng* this Court was similarly concerned with the source of commissions in respect of transactions on overseas stock exchanges alleged to have been carried out on the instructions of the taxpayer, a Hong Kong company acting for clients outside Hong Kong.

136. In order to overcome the perceived difficulty that the profits in question were derived from the operations of the stockbrokers and not its own, the taxpayer argued that it had itself executed its clients' orders, albeit acting through agents. For this argument, the taxpayer relied on the maxim *qui facit per alium facit per se* and the notion that the acts of an agent are those of the principal. In relation to this submission, Mr Justice Bokhary PJ observed at para.51:

“... I note the observation in *Bowstead and Reynolds on Agency* 18th ed. (2006) para.1-027 (at p.21) that ‘such a complete identification is usually regarded as inappropriate’. And I agree with the statement in that paragraph (at pp 21-22) that though approaching an agent’s acts as those of the principal ‘has value in imposing some unity on the law applicable to situations where one party represents or acts for another, it should not be taken too literally’”.

137. In *Kennedy v. De Trafford* [1897] AC 180 Lord Herschell observed (at p.188) that “No word is more commonly and constantly abused than the word ‘agent’”. An agent properly so called is a person who acts on behalf of another, called the principal, *so as to affect the principal’s legal relations with a third party*: see the definition in *Bowstead and Reynolds on Agency* (*op. cit.*) p.1. Where a contract is entered into by an agent acting on behalf a principal, it is the principal who obtains rights and incurs liability under the contract, not the agent. In such a case it is not inaccurate to describe the contract as the contract of the principal and not the agent.

138. But many professional persons who act for clients and who are popularly described as agents are not agents in this sense at all. Estate agents are an obvious example. Stockbrokers are another. They transact business on the stock exchange as principals, not as agents for their clients. Stockbrokers are liable as principals on the contracts which they make with each other; their clients have no liability under those contracts. The only contractual liability which the client undertakes is to his own stockbroker under the contract between them in which each acts as principal.

139. In considering the source of profits, however, it is not necessary for the taxpayer to establish that the transaction which produced the profit was carried out by him or his agent in the full legal sense. It is sufficient that it was carried out on his behalf and for his account by a person acting on his instructions. Nor does it matter whether the taxpayer was acting on his own account with a view to profit or for the account of a client in return for a commission.

140. In *Commissioner of Income-Tax v. Chunilal Mehta* (1938) L.R. 65 Ind. App. 332 (“*Mehta*”) the taxpayer carried on business in Bombay as a broker in commodity futures and also, as a regular business, entered into contracts on his own behalf: see the judgment of the High



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Court of India (1935) I.L.R. 59 B 719. Profits and losses from contracts which he entered into on his own account belonged to him. In regard to business carried out for his clients, he charged commission and any profits or losses belonged to them. For transactions on overseas markets he employed brokers who dealt on the relevant market. The taxpayer carried on business from an office in Bombay, and everything which he did to earn the profit he did in Bombay. The Commissioner argued that the fact that he had to employ brokers outside British India did not mean that what he earned by his own efforts in British India was earned where the brokers were located. The Privy Council disagreed. Giving the opinion of the Board Sir George Rankin said at p.345:

“It is difficult indeed to see that the place at which a man takes a decision to do something in New York, *or to ask someone else to do something for him in New York*, is the place at which arises the profit which results from the action taken in consequence of the decision. . . . It can hardly be maintained that whatever a man decides upon in Bombay, and whatever may be done abroad in pursuance thereof, the profit must necessarily arise in Bombay. One must look at the transaction to see what happened in British India and what happened elsewhere. . . .

“To determine the place at which such a profit arises not by reference to the transactions, or to any feature of the transactions, but by reference to a place in India at which the instructions therefor were determined on and cabled to New York is, in their Lordships’ view, to proceed in a manner which cannot be supported if the transactions are to be looked at separately and the profits of each transaction considered by themselves.”

141. The Board held that the transactions were indeed to be looked at separately and the profits of each transaction considered by themselves. It rejected the Commissioner’s argument that because everything which the taxpayer did, in particular the decision to engage in each transaction and the giving of instructions to the overseas brokers to carry it out, was done in British India, it followed that the profits arose in British India.

142. The overseas brokers who carried out the taxpayer’s instructions in that case did so as principals and not as agents. But the opinion of the Board contains no reference to agency and does not depend on any supposed identity of the agent and his principal. It was sufficient that the profits arose from transactions entered into by brokers acting on the taxpayer’s instructions and for his account. The same was true of *Hang Seng Bank*.

(iii) *The source of profits earned by way of commission*

143. The Board of Review distinguished *Mehta* on the ground that in that case the profits in dispute were the profits of the taxpayer’s own trading and did not include commissions earned by dealing on behalf of clients. This is simply not correct. The taxpayer was assessed on the whole of his profits whether they consisted of commissions earned in the course of his business as a broker

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or from trading on his own account; and given the position taken by the Commissioner it could hardly have been otherwise. The High Court of India held that all the profits arose outside British India and made no distinction between commission income and trading profits; and the Privy Council dismissed the Commissioner's appeal.

144. It is true that the example which the Board took for illustrative purposes was of a transaction undertaken by the taxpayer on his own account, but it drew no distinction between such transactions and those which he undertook in the course of his business as a broker. Nor would its reasoning admit of any such distinction. All the profits derived from transactions on overseas markets and resulted in money being held by brokers overseas which, in the Board's words, as between them and the taxpayer belonged to the taxpayer. The fact that some of the money consisted of commission payable to the taxpayer and some of dealing profits which belonged to his clients would not affect their source but only the accounting between the taxpayer and his client.

145. In *Mehta* the taxpayer's profits in those cases where he acted for clients consisted of the net commission representing the difference between the commission he paid to the brokers who carried out the transactions (which was an expense) and the larger commission he charged to his own clients. His right to retain the net commission was a contractual right which arose under the contract with his client. But the geographical source where his profit arose was not the place where the contract was entered into (which was Bombay) but the place where it was performed. He contracted to render a service, and the net commission arose in the place where he rendered it: see the passage previously cited in the opinion of Lord Bridge in *Hang Seng Bank*.

146. Nor did the taxpayer earn his commission in the place where he gave instructions to the brokers (which was Bombay) but in the place where they carried them out. Clients did not employ the taxpayer merely to give instructions to the overseas brokers or, as Counsel for the Commissioner argued before us, "to arrange for the proposed transactions to be carried out"; but to have them carried out. The taxpayer carried out his clients' instructions by cabling the overseas brokers; but this was not the service he was engaged to perform but the means by which he performed it. Whether the taxpayer was trading on his own account or for clients, the only act which he performed in British India was the same, viz. to give instructions to the overseas brokers. It can hardly be supposed that the same act should produce profits in one place when it consisted of giving instructions on his own account and in another when it consisted of giving them on behalf of a client, particularly when he could (and for all we know occasionally did) include in a single order to his brokers instructions to buy or sell the same commodity for himself as well as his clients.

147. In summary (i) the place where the taxpayer's profits arise is not necessarily the place where he carries on business; (ii) where the taxpayer earns a commission for rendering a service to a client, his profit is earned in the place where the service is rendered not where the contract for commission is entered into; (iii) the transactions must be looked at separately and the profits of each transaction considered on their own; and (iv) where the taxpayer employs others to act for him in

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carrying out a transaction for a client, his profit is earned in the place where they carry out his instructions whether they do so as agents or principals.

148. But for some *dicta* of Lord Scott of Foscote NPJ in *Kim Eng* I would have considered the foregoing to be beyond dispute. In that case the taxpayer, a company carrying on business in Hong Kong, claimed to have transacted business on behalf of overseas clients (*inter alia*) on the Singapore stock exchange through Singapore brokers. The Board of Review found that in fact the overseas clients gave their instructions directly to the Singapore brokers and the taxpayer was retrospectively interposed as counterparty only after the transaction was complete. This Court regarded it as the critical feature of the case that the taxpayer's involvement took place after the event. The taxpayer earned its commissions not from transactions in Singapore which had already taken place but from taking part in what Lord Scott NPJ described as "a dressing-up arrangement" which was orchestrated and implemented in Hong Kong.

149. Unfortunately, at the end of his judgment Lord Scott NPJ discussed *obiter* what would have been the position had the taxpayer's involvement been genuine and preceded the share transaction. He said at para.71:

"On the alternative scenario, which did not, in my opinion, accord with reality, the Taxpayer's profit was earned from its contractual arrangement with its client. The opportunity to earn the profit would have been derived from the Singapore share transaction between [the Singapore broker] and the Taxpayer, but I do not think that would be enough. If a Hong Kong client instructs a Hong Kong stockbroker to arrange a purchase or sale [of] shares on the Singapore Stock Exchange on the footing that the client will reimburse the Hong Kong broker the amount of the commission payable to the Singapore broker and will, in addition, pay the Hong Kong broker a sum equal to 50 per cent of that commission, I would regard the profit made by the Hong Kong broker in executing those instructions as sourced in Hong Kong."

150. I respectfully disagree. I do not know what more would be required to locate the profit in Singapore. It is not, with respect, correct to say that the taxpayer's profit was earned from its contractual arrangement with its client while the Singapore share transaction merely provided it with the opportunity to earn the profit. This gets it the wrong way round. The contract with the client gave the taxpayer the opportunity (or more accurately the right) to earn commission which it did by giving instructions for the Singapore share transaction.

151. In my opinion Lord Scott NPJ's conclusion is at variance with the authorities to which I have referred and in particular with the decision and the reasoning of the Privy Council in *Mehta*. It is true that the right to commission is a contractual right which derives from the contract between the taxpayer and his client, but the profit represented by the net commission arises in the place where the contract is performed, not where it is made. If the taxpayer is employed to take part in

a charade, this may be the place where the arrangements for the charade are made. But if the taxpayer is employed by a client to carry out a transaction on an overseas exchange, acting through brokers who deal on that exchange, then both in principle and on the authorities the profit arises in the place where the transaction is carried out. Lord Scott NPJ was describing a transaction in which the taxpayer acts on the direct instructions of the client, but it cannot make any difference to the place where his profit arises that the party who employs him is acting not on his own account but for a client of his own.

### ***The Board of Review***

#### *(i) The form and contents of the Case Stated*

152. Appeals from decisions of the Board of Review are by way of Case Stated. Appeals are on law only; it is the Board's function to find the facts. The role of the Court is limited. It will set aside the Board's decision only where its determination is erroneous in point of law, where there is no evidence to support a particular finding of fact, or where the only reasonable conclusion on the facts which the Board has found contradicts its determination.

153. In stating a case for the opinion of the court, the Board should set out as clearly and succinctly as possible (i) the facts agreed between the parties; (ii) the further facts found by the Board; (iii) any facts alleged by either party which the Board has found not established with brief reasons for its finding; and (iv) the legal principles which it has applied to reach its determination. It is customary to annex the Decision, not for the purpose of explaining or amplifying the Case Stated, but so that the court can understand the Board's reasoning.

154. In the present case the Board found that the Taxpayer had not discharged the burden of showing that the assessment was wrong. In such a case it is incumbent on the Board to set out in the Case Stated as briefly as possible both the facts which it has found and the facts which it considers that the taxpayer needed to prove but had failed to establish. The court can then decide whether, as a matter of law, the unproved facts are material and, if so, whether the evidence was sufficient to establish them. Even in such a case it should rarely be necessary to annex the whole of the evidence. If either party is dissatisfied with the contents of the Case Stated, it can ask the Board to amend or supplement it. If a party wishes to contend on appeal that the Board has overlooked a relevant piece of evidence or has made a finding which is contradicted by the evidence, it can ask the Board to annex the relevant part of the evidence. If it wishes to contend that the Board has made a finding which is unsupported by the evidence, it can ask the Board to identify the evidence on which it has relied.

155. In the present case the Board's Decision took up more than 50 pages of single-spaced typing. In the Case Stated, the Board extrapolated parts of the Decision and summarised other parts and then annexed the entire Decision to the Case Stated together with copies of the written and transcripts of the whole of the oral evidence. The Case Stated and Annexures ran to more than 520 pages altogether, of which some 220 pages consisted of

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transcripts of the oral evidence. This was quite unjustified. Properly understood, the point at issue was a narrow one and the relevant facts were in a relatively small compass.

156. As it is, the Decision and Case Stated consist of a lengthy threnody in which crucial findings of fact are scattered among complaints of the absence of information on matters which were at best peripheral or at worst wholly irrelevant. The Board wanted to know every detail of the way in which the Barings group carried on business, but even in relation to the disputed profits it complained about the lack of evidence on matters which had no bearing on their source. It found it “curious” that trades in securities listed on major markets outside Asia were not included among the disputed profits, since the evidence showed that the Barings group acted for clients in equity markets in Latin America and other emerging markets. The obvious explanation, that the Taxpayer (as distinct from the group) was not involved in and earned no commissions from such trades, does not seem to have occurred to it. It complained that it had no information about how orders originating from clients in North America were dealt with, although the disputed profits did not include commissions from any such orders; and lamented that it was unsure whether the commission income which formed part of the disputed profits was the gross commission paid by the client or the commission paid by the Taxpayer to the executing broker or whether they were the same, although a moment’s reflection would have told it that since the figures had been agreed as representing the Taxpayer’s profits, the only issue being whether they were taxable, it was the net commission retained by the Taxpayer after deducting commissions paid from commissions received.

157. Even in relation to matters which were directly relevant, the Board tended to employ language which left it in doubt whether it was making a finding of fact or merely summarising the evidence. It introduced important factual matters by saying that “the evidence suggested” without expressly stating whether or not it accepted the evidence. It annexed a valuable and detailed table, broken down by the several Asian markets on which transactions took place, which identified the particular entity responsible for each of the steps taken to carry out the client’s instructions; but headed the table “Summary and Comments on Evidence ...”. I think that the Court of Appeal were wrong to criticise the judge for treating the table as findings of fact. It is difficult to understand why it was included unless it represented evidence which the Board accepted subject to the qualifications which it contained.

158. Any tribunal of fact may be forgiven for misunderstanding the evidence and reaching erroneous findings of facts in a complicated case. But it abdicates its duty if it leaves room for argument as to what are the facts which it has found.

(ii) *The Board’s reasoning*

159. The Board began by referring to the 1998 edition of the Departmental Interpretation and Practice Note No.21 issued by the Revenue. It recognized that the Taxpayer’s profits were “service fee income” and that such profits arise in “the place where the services are performed

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which give rise to the payment of the fees”. So far it was undoubtedly correct. But it made no attempt to identify the services for which the Taxpayer was paid or the place where it performed them. It sought to apply Lord Jauncey’s formulation of the fundamental question in *HKT VBI* at p.411 as “what were the operations of the taxpayer which produced the relevant profit”. But it failed to appreciate that the concluding words “which produced the relevant profit” are words of limitation which restrict the enquiry to the particular operations which earn the profit. Nor did it heed the direction of the Privy Council in *Mehta* to look at the profit-making transactions separately and consider the profits of each transaction by itself, (a direction which could hardly be meant to apply to transactions which the taxpayer carried out on his own account but not to transactions carried out for clients). It sought to identify all the activities in which the Taxpayer engaged in the course of its business on the footing that they all contributed in varying degrees of importance to its ability to make profits, and to determine which of them took place in Hong Kong and which elsewhere. Even if it had succeeded in doing this, it is unclear to me how it would have helped to resolve the question in issue. The only result was that the Board was overwhelmed by the mass of detail which it had to digest.

160. I think that the Board allowed itself to be misled by the way in which the evidence was given and the market jargon employed by the Taxpayer’s witnesses. They described the subsidiary in the location where the client was based as “the sales desk” and its business as “selling the product”. In reality, of course, “the product” which it was “selling” was its own services. The witnesses stressed, and were extensively cross-examined by the Commissioner to establish, the quality and importance of the Barings group’s research and the efforts of its employees (no doubt by winning and dining important clients) in attracting and maintaining its relationship with clients. All this was, no doubt, of great commercial importance to the development of the business of the Barings group; but it was not the service for which the clients paid.

161. This coloured the whole of the Board’s approach. It devoted a substantial proportion of its Decision to an elaborate analysis of the work of the Research and Sales Division, and many of its complaints of the lack of information related to these aspects of the business. It accepted the Taxpayer’s evidence that research and sales were as important to its business as the execution of client trades but failed to appreciate that the latter represented the services which generated the disputed profits and the former did not. In bemoaning the absence of information concerning the relationship of the clients and the Barings group, it stated that

“As sales were an important element in the Agency Brokerage business, facts which related to [the client agreements] would be important relevant facts which would be required to determine the territorial source of the disputed income. The place where the sales took place, the place where the client contracted with [the Taxpayer], the governing law of the contract, the place where client placed the client order, the place where communications with client occurred, where client initiated payment of the Client Commission, the instructions given to client as to the method of payment and

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similar issues would be important areas to be addressed when looking at the locality of the profits produced as a result of these sales and contracts signed with clients ...”

None of these matters was of the slightest relevance to the narrow question which the Board had to decide. It was not called on to consider how or where the Taxpayer attracted its clients, but merely to determine the places where it rendered the services for which it earned the disputed profits. If a client in country A instructs a taxpayer in country B to perform a service in country C in return for a fee, the fee is earned in country C. How and where the taxpayer obtains the client’s business in the first place is completely irrelevant.

162. The Board considered that the Taxpayer had understated the extent of the activities which it carried out in Hong Kong. In para.21 of the Case Stated it said:

“... From the evidence, the Board found that the Taxpayer undertook functions which exceeded that of the Taxpayer being merely a local office handling only Hong Kong clients or merely executing client trades as the executing entity in Hong Kong or merely booking client trades of securities listed in the Asian markets. It was more of a regional office of the Group in the Asian Pacific region. It was its home base for the Asian Pacific time zones. *It received client orders originating from outside the Asian Pacific region in respect of securities traded in Asian Pacific markets and passed them on to the relevant executing entities in the relevant markets (sometimes through another Group company in the region). It provided services to Hong Kong clients for trading of foreign securities.* It housed the back office computer equipment (with the exception of Japan and perhaps Singapore). Sometimes, the Taxpayer’s involvement in respect of foreign securities were more intense, such as the Philippines. And there were also situations where the Taxpayer’s involvement may have been much less, such as Japan.” (emphasis added).

The sentences emphasised in the above passage describe the services from which the disputed profits arose, and the only question which the Board had to decide is where they took place. Everything else was irrelevant. But the Board wrongly thought that it was significant that the Taxpayer did many other things in Hong Kong which were a necessary part of its business even though it did not earn the disputed profits by doing them.

(iii) *The Board’s conclusion*

163. The Board rejected the Taxpayer’s argument that the disputed profits arose in or derived from the places where the clients’ orders were executed, that is to say on the various overseas stock exchanges, because it

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“... was not supported by the Taxpayer’s contention as to the importance of both research and sales. The place of execution was an important factor but it was not the only factor.”

164. The Board concluded that the Taxpayer had not discharged the burden of proof of showing that the assessments were incorrect or excessive. It summarised its reasons in the Case Stated as follows:

- “(i) The inability [to] clearly categorize the different types of income and the aggregation of the Marketing Income and the Commission Income in the evidence and submissions of [the Taxpayer];
- (ii) The imprecision of the evidence and its generality;
- (iii) The inability of the [Taxpayer] to relate the evidence adduced in the hearing (a) to the accounts of the [Taxpayer] and, more importantly, (b) to the various figures in the disputed incomes.”

In fact the parties had formally agreed the three categories of income in issue, viz. commission, placements and “marketing”, and their nature was the subject of specific evidence which the Board accepted. The Board’s criticism of the aggregation of “Marketing” Income and Commission Income was misplaced, since both were forms of commission and were assessed as such. The “imprecision” and “generality” of the evidence appears to relate primarily to the Board’s confusion about the distinction between “Marketing” and Commission Income, or to irrelevant matters. The Taxpayer’s “inability to relate the evidence adduced to the accounts and, more importantly, to the various figures in the disputed incomes” demands more than is required of a taxpayer in a case like the present where all the relevant figures are agreed.

***The judgment of Barma J***

165. The judge began by rejecting the Taxpayer’s contention that it was wrong to focus on the Taxpayer’s acts and that it was necessary to identify the operations, whether of the Taxpayer or of other members of the Barings group, which gave rise to the disputed profits. He concluded correctly that it was necessary to identify the operations of the Taxpayer which gave rise to the disputed income. In doing so he appreciated that the operations in question are doubly qualified: first, they must be the operations *of the taxpayer*; and secondly, they must be the operations *which give rise to the profits in question*.

166. The judge rightly rejected the Commissioner’s reliance on “sales” and search, as these were not the operations from which the disputed profits arose. They “brought in the clients”, but it was the individual transaction which the Taxpayer carried out at the behest of the client which



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earned the fees. Far from “losing sight” of the proper test, as the Court of Appeal thought, the judge consistently sought to apply it.

167. Nor did the judge assume the Board’s fact-finding role as the Court of Appeal claimed. Rather he embarked on the task of attempting to discover just what were the relevant facts which the Board had found. This was no easy matter, and the Judge was compelled to describe some of the Board’s crucial findings as “implicit”.

***Conclusions***

168. I have already rejected the Court of Appeal’s criticisms of the judge’s approach, and can turn at once to the proper conclusions to be drawn from the Board’s findings of fact in relation to each of the three categories of disputed profits.

(i) *Commissions*

169. These consisted of the net commissions retained by the Taxpayer after deducting commissions paid from commissions received. All commissions were in respect of dealings for clients in securities on overseas exchanges. Such dealings were carried out either on the instructions of the client itself, at least where it was a Hong Kong client, or on the instructions of another member of the Barings group (known as “the sales desk”) which in turn was acting on the instructions of the client.

170. In the Case Stated the Board described the manner in which orders were passed from the overseas sales desk to the executing entity (at para.18) as follows:

“The passage of client orders in the Group took place as follows. The workflow commenced at the point where the sales desks, having received the client orders, passed on the client orders to the Taxpayer or the Group company located in the market of the securities to be traded. The evidence suggested either (i) the client orders for securities to be traded in the Asian markets were passed on by the sales desks to the Taxpayer which were then passed on to the relevant Group company located in or near the market of the securities to be traded or (ii) client orders were passed simultaneously or nearly contemporaneously to the Taxpayer and the relevant Group company located in or near the market of the securities to be traded. The relevant Group company located in or near the market of the securities to be traded would then execute the client trade if it were an executing entity or it would ensure that a third party executing entity would execute the client trade in the market.”

Exceptionally the client would place an order directly with the executing entity, but this was the exception rather than the rule.

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171. It seems that overseas orders were always transmitted by the sales desk to the Taxpayer (by telephone if in overlapping time zones and otherwise by fax or telex), although they were sometimes also transmitted direct to the subsidiary in the execution location. It is not clear from the Board's Decision whether the Taxpayer passed the order on where the sales desk had already communicated the order to the subsidiary in the execution location; but it probably did, since it is unlikely to have known that the order had already been or shortly would be communicated directly by the sales desk.

172. In my opinion all the commissions derived from transactions which took place overseas, whether they were carried out on the instructions of clients of the Barings group or of other members of the group acting for such clients, and whether the Taxpayer placed the orders directly with overseas brokers or instructed other members of the Barings group to do so.

(ii) *Placements*

173. Placement Income was very similar. The Board found that it was "the commission earned from clients in the purchase of new shares issued or to be listed outside Hong Kong". In an obscure passage of its Decision the Board said that the Taxpayer was involved in two ways. It would

- “(i) procure local and overseas investors to subscribe for securities and bond issues which [other members of the Barings group] were underwriting in the Asia region.
- (ii) [It] would also undertake the selling of certain holdings of securities in connection with such underwriting by the other [members of the Barings group].”

No one could understand to what (ii) referred. The evidence recited in the Decision was that the Taxpayer would obtain orders for new issues from clients in Hong Kong and overseas subsidiaries and pass them to the subsidiary in the location where the shares were being issued. The Taxpayer would receive a commission for the successful placement of the issue.

174. This might suggest that the Placement income was in reality sub-underwriting commission, but we were told (without objection from Counsel from the Commissioner) that this was not the case. The Taxpayer did not act, whether directly or indirectly, for the underwriters but for clients who wished to subscribe for the shares. But it does not matter whether the income represented sub-underwriting commission paid by the underwriters or commission paid by subscribers, because the result is the same in either case; the commission was earned in the place where the shares were subscribed for, and that was overseas.

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(iii) “Marketing” income

175. This is something of a misnomer. In most cases it was simply an introductory commission received from overseas subsidiaries for the introduction of clients (usually Hong Kong clients). If a client in Hong Kong placed an order for an overseas transaction with the Taxpayer, the Taxpayer would instruct the subsidiary in the execution location to carry out the order and would earn a commission for doing so. In addition, however, the overseas subsidiary would pay the Taxpayer an introductory fee or commission equal to one half of the net commission which it would retain for its services after having deducted both the commission paid to the executing broker and that paid to the Taxpayer.

176. An introductory fee is earned where the introduction is made, i.e. where the party to whom the introduction is made is located, since an introduction is valueless (and indeed is not effected) until it is received.

177. The position in regard to the Korean market was different. The Board found that this was paid to compensate the Taxpayer for employing a key executive who handled Korean securities. He was employed both by the Taxpayer for work in Asia and by other members of the Barings group for his work in London; but the whole of the commission income which he generated was paid to the companies in London. This seems to have been a rough and ready allocation of commission income, and since the whole (or at least the greater part) of the commission which he generated would appear to have derived either from transactions in Korea or Europe the share received by the Taxpayer should be treated as arising outside Hong Kong.

178. The “Marketing” Income could be said to represent an arbitrary allocation of commission in respect of overseas transactions. The Commissioner described the process as being one of “commission splitting” and that is not inaccurate. It represented a decision by the Barings group as to the proper allocation of earnings within the members of the group. But that does not determine the geographical source of the income. To do this, it is necessary to ascertain what the Taxpayer had to do to earn the commission and, for the reasons previously stated, this was outside Hong Kong.

***Disposal***

179. In my opinion, on the facts found by the Board, all the disputed profits arose in or derived from outside Hong Kong and were accordingly not chargeable to profits tax in Hong Kong. I would allow the appeal, set aside the Order of the Court of Appeal and order that the assessments for each of the relevant years should be reduced by excluding the disputed profits. I agree with the other members of the Court that costs should be dealt with by written submission and that the composition of the Board of Review should be re-considered.

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**Mr Justice Bokhary PJ:**

180. The appeal is allowed. The Order of the Court of Appeal is set aside and it is ordered that the assessments for each of the relevant years be reduced by excluding the disputed profits. It is directed that costs be dealt with on written submissions as to which the parties should seek procedural directions from the Registrar.

(Kemal Bokhary)  
Permanent Judge

(Patrick Chan)  
Permanent Judge

(R A V Ribeiro)  
Permanent Judge

(G P Nazareth)  
Non-Permanent Judge

(Lord Millett)  
Non-Permanent Judge

Mr David Goy QC and Mr Barrie Barlow SC (instructed by Messrs Mallesons Stephen Jaques)  
for the appellant

Ms Gladys Li SC (instructed by the Department of Justice) for the respondent

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