Case No. D10/91

Profits tax – whether interest earned on share subscription moneys was taxable because it arose through or from the carrying on of its business – section 15(1)(f) of the Inland Revenue Ordinance.

Panel: Denis Chang QC (chairman), Larry Kwok Lam Kwong and Tse Tak Yin.

Dates of hearing: 22, 23 and 24 January 1991.
Date of decision: 3 May 1991.

The taxpayer which carried on business in Hong Kong earned interest on moneys which paid to it by persons who were applied for shares which it was selling publicly. The interest was taxed by the assessor as being interest which accrued to the taxpayer which was carrying on business in Hong Kong without regard as to whether or not the interest related to the business. This was in accordance with section 15(1)(f) of the Inland Revenue Ordinance in a previous and subsequent form. Section 15(1)(f) at the material time stated that only interest which arose through or from the carrying on of the business would be subject to tax.

Held:

The Commissioner in his determination had clearly made a mistake with regard to the wording of section 15(1)(f) at the material time. However this did not mean that the taxpayer would necessarily win the appeal. It was necessary for the Board to consider the case and its facts in the light of the correct law. On the facts before it, the Board held that the taxpayer when it offered shares to the public was realising a capital asset and that the interest earned on the moneys paid by applicants was attributable to the sale of a capital asset and did not arise through or from the carrying on by the taxpayer of its business.

Appeal allowed.

Case referred to:

D17/88, IRBRD, vol 3, 232

S P Barns for the Commissioner of Inland Revenue.
Anthony L Brown of Price Waterhouse for the taxpayer.

Decision:

The point at issue is whether income described as 'interest' in the sum of $3,821,344 which accrued to the Taxpayer in early 1985 from the deposit of application monies for shares in X Limited under a public offer is chargeable to profits tax.

The Revenue contends that the income in question is caught by the deeming provision contained in section 15(1)(f) of the Ordinance and/or alternatively by section 14 thereof (the charging section).

The wording of section 15(1)(f) with which we are concerned is different from what it was prior to 1 April 1984 and from what it is now.

The old section 15(1)(f) in existence prior to 1 April 1984, which does not apply to the present case, provided that 'sums received by or accrued to a corporation carrying on a trade, profession or business in the colony by way of interest derived from the colony' would be deemed for the purpose of the Ordinance to be receipts arising in or derived from the colony from a trade, profession or business carried on in the colony.

The provision was however amended by section 3 of the Inland Revenue (Amendment) Ordinance with effect from 1 April 1984. The amended section 15(1)(f) read:

> ' 15(1)(f) sums received by or accrued to a corporation by way of interest arising through or from the carrying on by the corporation of its business in the colony, notwithstanding that the moneys in respect of which the interest is received or accrues are made available outside the colony.'

The said amended section 15(1)(f) was the provision in operation at all times relevant to the present appeal. [This sub-section had since been amended and restored to its old form and now reads: 'sums received by or accrued to a corporation carrying on a trade, profession or business in Hong Kong by way of interest derived from Hong Kong'].

Thus, under the law applicable to the present case, the test as to whether any sums received were caught by the deeming provision is not whether the sum received by the corporation was by way of interest derived from Hong Kong but whether the interest arose 'through or from the carrying on by the corporation of its business in Hong Kong'.

The Commissioner clearly misquoted the applicable section 15(1)(f) when he said in his determination that section 15(1)(f) 'provides that sums received by or accrued to a corporation carrying on a trade, profession or business in Hong Kong by way of interest derived from Hong Kong shall be deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong'. He found that the sums received were caught by section 15(1)(f), that it did not form part of the capital

proceeds of the sale of shares and that even if it did the provision in section 14 which excluded profits arising from sale of capital assets from the charge had no application once the receipts were caught by the deeming provision contained in section 15(1)(f).

In this appeal it is not enough to show that the Commissioner false-footed himself or that his reasoning was otherwise flawed; the Taxpayer has to show that the assessment as confirmed by the Commissioner was wrongly made that is the sums received had been wrongly brought into charge.

We find the following facts:

1. The Taxpayer was incorporation in Hong Kong in 1947 as a private company and was at all material times carrying on business in Hong Kong.

2. The principal activities of the Taxpayer were property owning, property development and investment holding.

3. The Taxpayer's accounts for the year ended 31 March 1985 which formed part of the profits tax return for the year of assessment 1984/85 disclosed what was described as an extraordinary item of $71,009,633 arising from the Taxpayer's disposal of shares in X Limited through a public offer for sale. Included in the item was the amount of $3,821,344 with which we are concerned from the deposit of application moneys for shares in X Limited.

4. The shares in X Limited disposed of by the Taxpayer as aforesaid were held by the Taxpayer as a long term investment.

5. The said shares were offered for sale together with other shares under a prospectus which prescribed procedures for applicants to follow. In addition to the offer price of $4.8 per share applicants were required to pay brokerage of one percent of the offer price plus buyer's stamp duty of $3 for each $1,000 of the offer price of shares allotted to successful applicants. The applications had to be made on prescribed forms and had to be lodged with a bank not later than noon (the date mentioned) together with remittances in Hong Kong dollars for the full amount payable. The prospectus imposed a condition that interest arising on the application moneys was for the account of the vendors of the shares.

6. All moneys received from the applications for the shares were paid into a separate bank account ('the offer account') with the bank in the name of Y Limited. Under an agreement in 1985 ('the underwriting agreement') Z Limited was authorised to appoint respectively the receiving bankers to receive and nominees to hold the application moneys received from the public issue. It was under the underwriting agreement that the bank and Y Limited were respectively appointed.

7. The parties to said underwriting agreement included X Limited, Y Limited, Z Limited, the Taxpayer and the other vendors of the shares. It was expressly stipulated in annexure 'F' to the underwriting agreement that all moneys received from the public issue were to be kept in the offer account until written confirmation was received from a registration company that valid share certificates had been sent to successful applicants.

8. Because of over-subscription, there was a surplus equal to about 98% of the total funds received. The total application monies received and held in the offer account were $8,793,285,497 (after taking into account the debit of over $6,000,000 for cheques returned unpaid).

9. The interest on the application monies was eventually divided among the vendors (including the Taxpayer) in proportion to the number of shares put into the offer by them.

There is no dispute that the shares of the Taxpayer included in the public offer were part of the Taxpayer's capital assets held for long term investment and that the Taxpayer had never apart from this instance participated in any public offers for the sale of shares held for investment purposes.

The Revenue also accepts and is contented to proceed on the basis that participation by the Taxpayer in the public offer did not itself constitute a trade or an adventure in the nature of trade.

The Revenue nevertheless contends, among other things, that the offer for the sale of the shares was an act done in 'the carrying on by the corporation of its business in Hong Kong' and that by that very fact alone the sums received by way of interest arose 'through or from the carrying on by the corporation of its business in Hong Kong'.

The Taxpayer, on the other hand, contends that the interest in dispute was clearly separated from the Taxpayer's business operations by the fact that it arose on funds which were clearly separated from its capital by the terms of the public offer, by the fact that the public offer was a capital transaction, and by the further fact that the Taxpayer was only one of several vendors taking part in the offer.

We think that the sums received by way of interest can rightly be regarded as arising out of a capital transaction, namely the realisation of the long term investment and thus formed part of the proceeds of realisation.

In other words the Taxpayer realised the investment by a method which enabled it to obtain not only the stated price for the shares but also a proportion of the interest on the application monies which included funds of unsuccessful applicants which were credited to the offer account but which never became part of the Taxpayer's capital. On the side of the

applicants, the loss of the interest was part of the opportunity cost; on the side of the Taxpayer, its share of the interest arising from the application monies became part of the proceeds of the realisation of its capital asset.

It should be noted that the interest arose at a time when the funds were still kept separated from the company's capital, a separation which incidentally was required by law [see section 44B(3) of the Companies Ordinance]. This is not a case where the interest was generated from funds of the business.

It is true that unlike the case of non-corporations [as to which see section 15(1)(g)] there was no requirement under section 15(1)(f) that the interest must be in respect of funds of the trade, profession or business. As stated above, however, section 15(1)(f) did require that the sums must be received by way of interest 'through or from the carrying on by the corporation of its business in Hong Kong'. These words are undoubtedly wide. 'But words, however wide, have their limits and where a company has, for example, put aside a sum of money in anticipation of declaring a dividend in the future, and in the meanwhile is receiving interest on the sum thus put aside, it would be difficult to argue that the interest was received "through or from" the carrying on by the company of its business. On the other hand if, in the course of its business, say that of selling goods, the company gave credit to its customers and earned interest thereon, it would be impossible to argue that such interest did not arise "through or from" the carrying on by the company of its business'. Case No D17/88.

The Revenue does not agree with the suggestion made in the case cited that setting aside company's funds for the purpose of paying dividends necessarily would have taken the interest arising outside the deeming provision. Be that as it may, what we are concerned with in the present case is not interest arising on funds taken out of the Taxpayer's business or otherwise set aside for particular purposes but with interest arising on funds no part of which had at the material time formed part of the Taxpayer's capital and a greater part of which never did form a part thereof. In our view, it was not interest generated through or by any business operation of the Taxpayer; the particular act of realisation of long term investment did not form part of the Taxpayer's business. In any event, as part of the proceeds of realisation of a capital asset the sums received escaped the charge imposed under section 14.

Accordingly, we allow the appeal and discharge the assessment.