Case No. D15/87

Board of Review:

H. F. G. Hobson, *Chairman,* Chiu Chun-bong and Francis G. Martin, *Members.*

3 July 1987.

Profits Tax—Sections 14 and 15(1)(*f*) of the Inland Revenue Ordinance—whether interest earned from certain deposits assessable to profits tax after 1 April 1984 following the 1984 amendment to the Inland Revenue Ordinance.

The Appellant company was assessed to profits tax on interest earned from certain deposits during the year of assessment 1984/85. There was no dispute as to the assessability of interest up to 31 March 1984. The Appellant denied liability for 1984/85 on the grounds that interest could never "arise through or from the carrying on of business" as contemplated by the 1984 amendment to Section 15(1)(*f*) of the Inland Revenue Ordinance. Alternatively, in the particular circumstances of the case, it did not arise "from carrying on business". The Appellant contended that following the 1984 amendment, interest to be taxable should flow from its business and not merely from a Hong Kong source. The Commissioner of Inland Revenue argued, however, that being a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business. On this basis depositing monies does constitute the carrying on of a business even where those monies are surplus to the company's immediate needs for working capital. The 1984 amendment was intended to extend the net to interest income derived abroad and did not render the original provision nugatory.

Held:

The activity of depositing can constitute a business. On the facts, in the light of the regularity and the size of the deposits the Appellant company was not merely engaged in temporarily "depositing surplus funds" but was conducting a separate business of depositing and interest was derived through the money making activity.

Appeal dismissed.

Cases referred to:

American Leaf Blending Co Sdn Bhd V Director General of Inland Revenue [1978] STC 561
Bank Line Ltd. v. CIR 49 TC 307
Bucks v. Bowers 46 TC 267
CIR v. Lo & Lo 2 HKTC 34
Esquire Nominees Ltd. v. FCT 4 ATR 75
C.I.R. v. Korean Syndicate 12 TC 181
Northend v. White & Leonard 1975 STC 317
C.I.R. v. South Behar Railway Co. 12 TC 657

D. O'Dwyer for the Commissioner of Inland Revenue.
D. Flux of Peat Marwick & Mitchell & Co. for the Appellant.

Reasons:

H Ltd. ("the Company") was assessed to tax on interest earned from certain deposits during the year of assessment 1984/85.

The Company accepts that the interest earned on those deposits down to 31 March 1984 was Hong Kong sourced and hence liable to tax by virtue of the provisions then extant of section 15(1)(*f*) (see 2.3(*a*) below) but deny liability for interest accruing during the remainder ("the Relevant Period") of the basis period on the grounds that interest (*a*) can never "arise through or from the carrying on of business", as contemplated by the 1984 amendment to the Inland Revenue Ordinance, alternatively (*b*) in this particular case did not arise from carrying on business.

1. *Primary Facts*

The following are culled from the Facts in the Commissioner's Determination which were not in dispute.

1.1 The Company, a private corporation was established in 1933.

1.2 Its objects include:—

> "(*n*) To invest and deal with the moneys of the Company not immediately required in such manner as may from time to time be determined."

1.3 During the Relevant Period, HK$254,317 was earned from HK dollar time deposits, HK$11,570 from a HK dollar savings account and HK$2,351,525 from foreign currency time deposits: the totalling HK$2,617,412 which is interest income in question.

2. *Case Law*

2.1 Mr. Flux appearing for the Company referred us to:—

2.1.1 Bucks v. Bowers (46 TC 267),

2.1.2 Northend v. White & Leonard (1975 STC 317),

2.1.3 IRD's Interpretation & Practice Note No. 13, para 18 and Example 4,

2.1.4 HK Revenue Law by Prof. P. G. Willoughby Vol. 2 page 2–208,

2.1.5 Silke on South African Income Tax (9th Ed.) paras 588 & 589,

2.1.6 Korean Syndicate (12 TC 202),

2.1.7 South Behar Railway Co. (12 TC 705),

2.1.8 the Third IRO Review Committee Report, and

2.1.9 the 1986 Budget Speeches.

2.2 Additionally Mr. O'Dwyer for the Revenue referred to:—

2.2.1 Esquire Nominees Ltd. v. FCT (4 ATR 75),

2.2.2 American Leaf Blending Co. Sdn. Bhd. v. Director General of Inland Revenue (1978 STC 561),

2.2.3 CIR v. Lo & Lo (HKTC Vol. 2 p. 34),

2.2.4 Bank Line Ltd. v. CIR (49 TC 307),

2.2.5 The UK Income Tax Act 1952, and

2.2.6 the 1984 Budget Speech.

2.3 The following are the pertinent statutory provisions and show the various forms(so far as material to this case) that section 15(1)(*f*) underwent:—

"14. Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in the Colony in respect of his assessable profits arising in or derived from the Colony for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part:"

"15(1) For the purposes of this Ordinance, the sums described in the following paragraphs shall be deemed to be receipts arising in or derived from the Colony from a trade, profession or business carried on in the Colony—"

(a) Pre 1.4.84:

"(*f*) 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"

(b) 1984 amendment:

"(*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 Hong Kong, *notwithstanding that the moneys in respect of which the interest is received or accrues are made available outside Hong Kong;*"

Note the omission of "carrying on a trade" etc. and the insertion of the italicized words.

(c) 1986 amendment:

"(*f*) 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;"

Note the reversion to (*a*) above.

3. *The Company's submissions*

A. *Primary Argument*

3.1 On the first ground of appeal, Mr. Flux submitted that the 1984 amendment was totally ineffective, however even if it were then he contended that the decisions in Bucks & Bower and Northend are authority for the proposition that interest can never arise from the carrying on of business.

3.2 The legislature doubting that interest necessarily qualifies as "profits" within the meaning of section 14 were driven to include it as a deemed receipt under s. 15(1). In the result prior to the 1984 amendment the test of whether interest was exigible to tax was "source" (which the Company conceded caught the interest accruing up to the 31 March 1984). The new wording, so Mr. Flux argued, substituted an "arising from business test" with the result that Hong Kong sourced interest was no longer automatically a deemed receipt.

3.3 Truncated into applicable language. s. 15(1)(*f*) is circulatory viz. "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 Hong Kong ….. shall be deemed to be receipts arising in or derived from Hong Kong from a business carried on in Hong Kong." and hence nonsensical.

3.4 If however interpretation were to be given to the apparent legislature intent to tax all interest no matter the source provided that if flowed to the recipient *from* his business then the following passage from Bucks and Bowers is authority for saying that interest cannot arise from the carrying on of business:—

"Quite apart from authority, I do not think that, in the context of an income tax Statute, one would naturally treat income received under deduction by a trader in the carrying on of his trade as "derived", still less derived by him *in the course* of that trade; but the word "*from*"

> suggests that the trade must be the source of the income, and that is not so in the case of income charged by deduction. The source of interest is not trade but the loan obligations from which the interest springs."

3.5 In Bucks & Bowers which was concerned with the definition of "earned income" which embraced "any income … immediately derived by the individual from the carrying on or exercise by him of any trade, profession or vocation", it was held that neither interest nor dividends received by partners in respect of securities acquired in the ordinary course of trade were immediately derived from the carrying on of the trade.

3.6 Mr. Flux went on to say that in case it should be thought that that ruling was confined to income received "under deduction" cases, the Northend case (where the receipt of interest, on client account deposits, by a solicitor was gross of tax) refuted any such suggestion.

3.7 Mr. Flux submitted that the quotation at 3.4 is of general application and is not therefore dependant upon UK tax legislation. Nor can the Revenue seek to make a distinction simply because our legislation uses the phrase "through" as an alternative to "from" because they are synonymous expressions. "From" implies "source", accordingly Pennycuick's comments is apposite i.e. even if the Company's interest could be said to have occurred in the *course* of its business it was not "*from*" its business (as might be said of interest on overdue accounts).

4. *Conclusions on the primary contentions*

4.1 We do not think we need to set out Mr. O'Dwyer's submissions in detail on the foregoing.

As regards the second aspect of 3.1 we have to decide whether the dicta of Pennycuick J is applicable to the facts before us.

4.2 Mr. O'Dwyer told us that earned income relief was introduced in 1952 as a recognition that the rewards to individuals from their own physical or mental efforts should receive tax relief. If Mr. O'Dwyer is correct in this, and Mr. Flux did not take issue, then it is not so surprising that the Judges in that and the Northend case should conclude that interest—whether received by a Rothschild partner or by a solicitor on his client's money—was not the type of earnings that legislature, in its magnanimity, had in mind. Nor is it particularly surprising that the use of the adjective "immediately" should be treated as implying that the proximity between effort and reward should be close. It is worthwhile quoting further from Pennycuick J's judgment:—

> "Again, the word "immediately" rather suggests that the trade must be the direct source, so as to exclude income derived from a different source itself owned by a trader in the

> carrying on of his trade. The distinction is a fine one, but is its, I thank, founded on the basic principles of the income tax code. Here too however, assistance is to be found in the speech of Lord Radcliffe in the F.S. Securities case. At page 694, after quoting the terms of s. 257 and s. 525 of the Act, he says: "It is plain therefore that in these special Sections about Surtax directions the Legislature has adopted the ordinary distinction between investment income and earned income that belongs to the tax code." So Lord Radcliffe is taking it for granted that that distinction between investment income and earned income forms part of the tax code. He goes on to say that it is plain that the same distinction is made applicable to the provisions concerning Surtax directions. There is thus a sharp dichotomy between investment income, on the one hand, and earned income, on the other hand, and it must follow that any item of income which is investment income cannot also be earned income. There was some discussion as to whether that statement should be regarded as a dictum, but if so, it is a dictum, but, if so, it is a dictum of the highest authority made in the course of laying down the basic principles applicable in this context, and I certainly propose to follow it."

4.3 Accordingly we have no hesitation in deciding that the quotation at 3.4 was not intended to have general application; it was intended quite clearly to be confined to the determination of "trade" and only in the context of earned income relief. The latter is totally alien to our own scheme of taxation and for that reason alone we believe that it would be quite inappropriate to pluck a single statement out of the ratio decidendi and attempt to apply it against an entirely different background.

4.4 Even if, though confined to "trade", we are wrong in supposing that the statement is applicable only in earned income relief cases we would have no difficulty in deciding that the statement was not intended to refer to "business" (which Mr. Flux conceded is of wider scope than trade) because it seems to us that in contra distinction to "trade" the core of many businesses lies in the acquisition of the legal obligations of others and, as a generality, we cannot see that legal obligations owned by a seller to a buyer differ in principle from those owned by a bank to a depositor. Whilst acknowledging that the latter is not per se a business of the depositor and that the former is more likely to constitute a business, both activities will depend on their own particular circumstances, so that regularity of the latter may constitute a business and a single occasion by a non-business-man in the former example may not.

4.5 It follows that we are of the opinion that there is in the issues before us a vast difference between "trade", as considered by Pennycuick J in the context of earned income relief and the expression "business" with which we are concerned. In passing we would mention that the UK "earned income relief" has been abandoned; apparently the fine distinctions to which it gave rise gave no one (legal and tax advisers excepted) much comfort.

Accordingly we find against the Company on this aspect of its first ground of appeal.

5. *The Revenue's submissions regarding the 1984 amendment*

5.1 The 1984 amendment was introduced to protect local institutions against the competition brought about by the placing through banking institutions having overseas branches of deposits in non-Hong Kong denominated currencies, thereby circumventing the "derived from the Colony" qualification. Often the placing off-shore was more contrived than real.

5.2 From 24 February 1982 by proviso (*g*) to s. 28(1) (i.e. the charge interest tax) interest on *foreign currency* deposits with financial institutions *in HK* was exempt from tax (thus destroying the tax attraction of routing deposits off-shore) at the same time the rate of taxation on the dollar denominated deposits was reduced to 10 p.c. (s. 28A). If the recipient carries on a business in Hong Kong then the interest is treated as part of its profits tax.

5.3 The foregoing amendment however tended to depress the Hong Kong dollar since why pay 10% tax when the depositor could avoid tax (and thereby improve his net yield to that extent) by placing his deposits in a foreign currency in Hong Kong. In consequence in October 1983 the 10% tax was abolished.

5.4 The result of the foregoing was that interest tax per se offered no deterrent, the profits accruing to businesses from the interest would still be liable to tax because of s. 15(1)(*f*). For that reason those who would otherwise suffer profits tax on interest earned took the off-shore route thereby avoiding profits tax.

5.5 It was this state of affairs which heralded in the 1984 amendment:—

> "I do not need to spell out in precise terms the details of the tax avoidance devices which are now available to business enterprises by virtue of the repeal of interest tax on deposits. In essence they involve … whilst at the same time the business proprietors can enjoy tax-free interest income outside the business through the placing of deposits with financial institutions. There is already evidence that bankers and tax avoidance specialists have set about advising customers and clients of the opportunities for tax diminution under the present law. The longer term prospects are that huge profits tax revenue could be lost. In all prudence immediate steps must be taken to minimize these losses while remaining themselves neutral in effect." (1984 Budget Speech)

5.6 Only the most powerful arguments Mr. O'Dwyer suggested, are admissible in arriving at a conclusion that legislature provisions are a nullity.

5.7 In dealing with the interpretation of the 1984 amendment Mr. O'Dwyer said that "Business" is a wider concept than "trade" and "in the case of a *company* incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business" (Diplock American Leaf at 565).

5.8 Accordingly so far as corporations are concerned depositing monies *does* (or in the alternative can do so and did on the facts of the appeal before this Board) constitute

the carrying on of business *even* where those monies are surplus to its immediate needs for working capital.

5.9 The pre 1984 provision caught interest derived in Hong Kong accruing to a corporation carrying on business in Hong Kong; by the use of the "notwithstanding … available outside Hong Kong," the 1984 amendment intended to extend the net to interest income derived abroad; it certainly did not intend to render the original provision nugatory. For sure s. 15(1)(*f*) was not singling out only money-lending or investment companies (which would in any case be exempt-along with other corporations—except for financial institutions specifically covered by s. 15(1)(i)—if Mr. Flux's primary argument were to prevail) for it has always been accepted that their liability for interest on local deposits arose under s. 14.

5.10 The placement of termporarily available funds at interest is part of the normal day-to-day operations of any business and is, in the present case, clearly an integral part of the Appellant's business since the interest accumulated over the years.

We do not think it necessary to dwell at this juncture upon Mr. O'Dwyer's answer to Mr. Flux's submission that the depositing by the Company in this instance was not a business.

6. *Conclusions on the effect of the 1984 amendment*

Mr. O'Dwyer's arguments (in particular 5.8 and 5.10 above) notwithstanding we believe, and so find as a matter of legal interpretation, that the legislation did attempt to differentiate between interest accruing through or from a business activity and interest accruing from the temporary deposit of surplus funds. Contrary to Mr. Flux's submission that the amendment was nugatory, we are of the view that it was repealed because, like the UK earned income relief provisions, the desired result could not be achieved: the difficulty lay in the inability to differentiate in "crisp legal language that left no room for ambiguity" (1986 Budget Speech).

7. *Conclusions on the secondary argument*

7.1 Having concluded that as a matter of both fact and tax law that the activity of depositing can constitute a business, the next question is whether the Company's activities in this regard did constitute a business even though it is not a financial or money-lending institution. Certainly in the past many stores in England (Lewis & Co. and C.W.S.) solicited and accepted deposits from their customers, redepositing with others, and that activity in due course led to the creation of their own banks. We think the same is historically true of Hong Kong.

7.2 Quite obviously there are grey areas of uncertainty, however we take the view that regularity and size would be two ingredients which would weigh in the balance; there may well be others. And it may be that the infrequency of large deposits and the

frequency of small deposits may of themselves be insufficient to tip the scales towards an inference of "business". In the instant case however we have both regularity (evidenced by the accumulation and deposit of profits between at least 1980 and 1984) and sizeable deposits, from $9m in 1980 to $83m in 1984.

7.3 In the light of these we find as a matter of fact that the Company was not merely engaged in temporarily "depositing surplus funds" but was conducting a separate business of depositing (within object (*n*), see 1.2 above). We should mention that no evidence was adduced to show that the funds were indeed surplus to the Company's business but even if they were they long ago lost any temporary characteristic.

7.4 If we are wrong in so deciding then we would be minded to conclude in the alternative that the interest earned was "through" (a term that we do not accept is synonymous with "from") the Company's business having regard to the fact that that business not only involved managing a company but making a profit therefrom (actually the primary object, the company being the medium for achieving that object). The money making activity being a business we believe that it would be correct to say interest from deposits, unless of a temporary nature, would be derived "through" (i.e. in consequence of) the money making activity.

7.5 All grounds having failed we hereby dismiss this appeal.